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No. 83- .

In the

Supreme Court of the United States.

OCTOBER TERM, 1983.

GOMEZ-HERMANOS, INC.,
APPELLANT,

v.

SECRETARY OF THE TREASURY OF PUERTO RICO,
APPELLEE.

ON APPEAL FROM THE SUPREME COURT OF PUERTO RICO.

Jurisdictional Statement.

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Questions Presented.

1. Whether it violates the due process clause and the interstate and foreign commerce clause for a state or commonwealth to impose a flat 29% tax on the gross income of lenders who maintain no property, agents, employees, offices or presence at all in the taxing state, merely because they have loaned funds to residents or businesses in the taxing state?

2. Whether the interest on loans involving more than one state may, under the commerce clause, be attributed without apportionment to the state or commonwealth that provides the market for the loans and then taxed at rates higher than those imposed on domestic lenders?

3. Whether a state or commonwealth violates the foreign commerce clause when it imposes such a tax on a foreign lender where the tax conflicts with federal policy and undermines federal uniformity in taxing foreign lenders and enhances the risk that the foreign lenders will be doubly taxed?

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ON APPEAL FROM THE SUPREME COURT OF PUERTO RICO.

Jurisdictional Statement.

Opinions Below.

The decision of the Supreme Court of Puerto Rico, per Trias Monge, C.J., dated June 10, 1983, is not yet officially reported in English and is reprinted as Appendix A. The Supreme Court decision reversed the judgment of the Superior Court of Puerto Rico, per Carmen Sonia Zayas, J. The Superior Court's decision is not officially reported in English and is reprinted as Appendix C.

Jurisdiction.

On December 15, 1975, appellant was notified by the Secretary of the Treasury of Puerto Rico of a tax deficiency in the amount of $1,428,300.20 (including interest and penalties) for tax years 1971, 1972 and 1973. The Secretary alleged that ap-

pellant was obligated under 13 L.P.R.A. §§ 3231(a) and 3144(a) to withhold at the source 29% of all interest paid to nonresident Japanese lenders. After appellant was denied reconsideration of the deficiency in administrative proceedings, it brought suit in the Superior Court of Puerto Rico, challenging under the due process clause the constitutionality of these tax statutes. The Superior Court sustained appellant's challenge. On appeal, the Supreme Court of Puerto Rico reversed, holding the statutes valid under both the due process and commerce clauses. On October 6, 1983, the Supreme Court of Puerto Rico denied reconsideration. (*See* Appendix B.) Appellant filed a timely notice of appeal to this Court in the Supreme Court of Puerto Rico on October 24, 1983. (*See* Appendix D.)

Because the Supreme Court of Puerto Rico's judgment sustained the validity of a statute of the Commonwealth of Puerto Rico, challenged on the ground of its being repugnant to the Constitution, this Court has jurisdiction of this appeal under 28 U.S.C. § 1258(2).

Constitutional and Statutory Provisions Involved.

The Fifth Amendment to the United States Constitution provides that:

> No person shall . . . be deprived of life, liberty, or property, without due process of law . . ..

The Fourteenth Amendment to the United States Constitution provides that:

> No State shall . . . deprive any person of life, liberty, or property, without due process of law. . . .

The Interstate and Foreign Commerce Clause of the United States Constitution provides that:

> The Congress shall have power . . . To regulate Commerce with foreign Nations, and among the several States. . . .

The pertinent provisions of the Puerto Rico Income Tax Act of 1954, 13 L.P.R.A. §§ 3231, 3144, 3013 and 3015 are reprinted as Appendix E.

Statement of the Case.

A. *Puerto Rico's Tax on Foreign Corporations Not Engaged in Trade or Business within Puerto Rico.*

The Puerto Rico Income Tax Act of 1954, as amended,[1] encompasses two separate corporate taxation schemes — one applicable to foreign corporations not doing business within Puerto Rico, the other applicable to all other corporations, whether foreign or domestic, engaged in business within the Commonwealth.[2] Section 3231(a) of the Act, the critical provision at issue here, levies on foreign corporations who engage in *no* trade or business within Puerto Rico the following tax:

> (A) Tax Levy. — There shall be levied, collected, and paid for each taxable year, in lieu of the tax imposed by sections 3013 and 3015 of this title, upon the amount received by every foreign corporation or partnership not engaged in industry or business within Puerto Rico, from sources within Puerto Rico, as interest (except interest on deposits with persons engaged in the banking business, and interest declared exempt under section 3022(b)(4) of this title), dividends, partnership profits, rents, salaries, wages, premiums, annuities, compensations, remunera-

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[1] The relevant portions of the statute in effect at the time of the dispute here are reprinted at Appendix E. The statute is currently codified, with amendments not material to this dispute, at 13 L.P.R.A. § 3001 *et seq.* (1976).

[2] 13 R.R.P.R. Art. 231-1 (the relevant tax regulations), explicitly establish this bifurcated tax system for residents and non-residents:

> (a) General. For the purposes of this article and articles 231-2, 232-1, 235-1, 235-2 and 236-1, foreign corporations or partnerships are divided into two classes:
> (1) Foreign corporations or partnerships not engaged in trade or business within Puerto Rico at any time within the taxable year, referred to in the regulations as non-resident foreign corporations or partnerships (*see* article 411-8); and (2) foreign corporations or partnerships which at any time within the taxable year are engaged in trade or business within Puerto Rico, referred to in the regulations as resident foreign corporations or partnerships (*see* article 411-8).

The lower tax rates for corporations which do business in Puerto Rico are set forth in Appendix E and currently codified at 13 L.P.R.A §§ 3013 and 3015 (1976). *See* pp. 18-20 *infra*.

tions, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, a tax of 29 per centum of such amount.

A statutory withholding responsibility for collecting the flat 29% tax on the *gross* income[3] received by nonresident corporations from Puerto Rican sources is imposed on the Puerto Rican resident from whom the foreigner derives the income.[4]

All interest on bonds, notes, or other interest-bearing obligations of residents of Puerto Rico, corporate or otherwise, with certain exceptions not relevant here, constitutes income from "sources within" Puerto Rico and, where the recipient is a nonresident foreign corporation, is subject to the 29% tax on gross income and to withholding at the source. 13 L.P.R.A. 3119(a)(1).[5] The nonresident foreign corporation is not entitled to any deductions or credits. The gross amount of interest received from Puerto Rican sources, without any apportionment, is subject to the 29% income tax levied by Puerto Rico. This applies to interest earned by nonresident foreign corporations on loans which are *unconnected* to property within Puerto Rico, even where the lender maintains *no* offices, employes *no* agents, and owns *no* property within Puerto Rico.

B. *The Financing Transactions at Issue.*

During the years 1971, 1972 and 1973, appellant Gomez-Hermanos, Inc. ("Gomez"), a corporation organized in Puerto Rico and engaged in the importation, distribution and sales of motor vehicles and accessories, entered into a series of inter-

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[3] *See* 13 R.R.P.R. Art. 232-1(b) ("for the purpose of section 231(a), the term 'amount received' means 'gross income.'").

[4] 13 L.P.R.A. § 3144(a) (1976), reprinted at Appendix E.

[5] During the taxable years involved in this case (1971, 1972 and 1973), the following items of income were considered from "sources without" Puerto Rico: (a) interest on deposits with persons engaged in the banking business; (b) interest paid by a resident who derived less than 20% of his gross income from sources within Puerto Rico during the preceding three-year period; (c) income derived by a foreign central bank of issue from bankers' acceptances, and (d) interest on mortgages secured under the National Housing Act of 1934 and obligations secured or guaranteed under the Servicemen's Readjustment Act of 1944. *See* 13 L.P.R.A. § 3119(a)(1).

national transactions which enabled it to finance its purchase of Toyota automobiles with the assistance of a Japanese trading company and several Japanese banks. The trading company involved was Tozer Kemsley & Millbourn Kabushiki Kaisha ("Tozer"), a Japanese subsidiary of a London corporation that was authorized by the Japanese Ministry of Industry Trading and Investment ("MITI") to arrange and oversee the exportation of Toyotas financed with loans from Japanese banks. MITI, an agency of the Japanese government, requires both that importers of Toyota automobiles obtain the assistance of a company like Tozer in financing their purchases and that the importer purchase MITI insurance that protects the banks, the trading company and Toyota from possible default by the importer.[6] Additional participants in the transaction were Fenchurch corporation, a foreign corporation which was a subsidiary of Tozer, with offices in New York, and the permanent New York offices of the several Japanese banks involved.[7] Neither Tozer, Fenchurch nor any of the Japanese banks engaged in any business within Puerto Rico.

During 1971, 1972 and 1973 the Japanese banks made various loans to Gomez to finance the purchase of Toyota motor vehicles through Tozer. The typical transaction proceeded as follows:[8] Gomez placed its order with Toyota in Japan with copy to Tozer. Toyota invoiced Tozer for the cars. After calculating its commission, the MITI insurance premiums, the shipping expenses, the interest to be paid to the financing Japanese bank and other miscellaneous expenses, Tozer would send its invoice to Gomez. Tozer would then obtain from the financing bank, in the name of Gomez, the amount necessary for full payment of the Tozer invoice to Gomez. A bill of exchange for the full amount advanced to Gomez at Tozer's request would be signed by Tozer, as maker or drawer, payable to the order of the financing bank at a

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[6] *See* A. 11 (Superior Court finding of fact ¶5).

[7] The Japanese banks with whom Gomez had credit lines included Sanwa, Mitsui, Mitsuibishi, Bank of Japan, and Bank of Tokyo. None do business in Puerto Rico. A. 11-12.

[8] There is no dispute as to these facts. The parties stipulated that trial exhibits relating to one particular transaction were typical of all such transactions. The details are summarized by the Superior Court at A. 12-14 and, more briefly, by the Supreme Court at A. 2-3.

definite time. The drawee was Gomez Hermanos, Inc. and the bill stated "value received and charge the same to account of Gomez Hermanos, Inc." In so doing, Tozer acted according to a power of attorney received from Gomez. The financing bank would then endorse the bill of exchange to the order of any bank, banker or trust company, all prior endorsement guaranteed, and would forward it to its office in New York with the original of the shipping documents. Upon receipt of the bill and shipping documents, the financing bank's New York agency would notify Fenchurch Corporation, Tozer's agent in New York. Fenchurch Corporation neither had offices in Puerto Rico nor carried out business in Puerto Rico nor had been authorized to do business in Puerto Rico. Acting as attorney in fact for Gomez, under the terms of a power of attorney, an officer of Fenchurch accepted the bill of exchange in the name of Gomez, obtained delivery of the original shipping documents and forwarded them to Gomez in Puerto Rico (together with a copy of the bill of exchange) so that Gomez would be able to obtain delivery of the purchased vehicles upon their arrival in Puerto Rico. Finally, on the date set for payment in the bill of exchange, Gomez would issue a check to the order of Fenchurch Corporation drawn against Gomez's account with a Puerto Rico bank for the full amount stated in the bill of exchange which included the interest to be paid to the financing Japanese bank. The check would be deposited in Fenchurch's New York bank account. Acting as Tozer's agent in New York, Fenchurch Corporation would then pay the Japanese bank, receive the original bill of exchange duly cancelled, and send it to Gomez in Puerto Rico. At no point in the transaction did Gomez make direct contact with the banks, by mail or otherwise; the only direct contact had been the original meeting in Japan with each bank to obtain lines of credit. The loans or credit lines granted by the financing Japanese banks to Gomez were secured only by the MITI insurance and never guaranteed by real property located in Puerto Rico.

C. *The Proceedings Below.*

On December 15, 1975, the Secretary of the Puerto Rican Department of the Treasury notified Gomez of a $1,428,300.20

tax deficiency for 1971, 1972 and 1973 — representing the sum (plus interest and penalties) that Gomez should putatively have withheld, pursuant to 13 L.P.R.A. § 3144(a), from payments of interest it made to the Japanese banks for the loans described above.[9] Immediately after notification, Gomez contested the deficiency notice and requested an administrative hearing. On September 20, 1977, the hearing was held. On November 14, 1977, the Director of the Income Tax Bureau denied reconsideration of the deficiency. On November 17, 1977, Gomez brought suit in Superior Court, alleging that the Puerto Rican source tax, as applied to interest paid by Gomez to the Japanese banks in question, violated the due process clause. Gomez argued[10] that because the banks had neither offices nor agents in Puerto Rico, did not make direct mail or phone contact with Gomez, and would not invoke the jurisdiction of the Puerto Rican courts if Gomez defaulted since the MITI insurance itself provided a guarantee of payment, the source tax as applied to the banks was unconstitutional for want of nexus.

On August 31, 1982, the Superior Court, per Carmen Sonia Zayas, J., sustained appellant's challenge to the tax, after making detailed findings of fact which placed every phase of the transaction outside Puerto Rico's territorial jurisdiction. Vacating the deficiency judgment, the court held that since the banks had not "established sufficient nexus, contacts or connections with Puerto Rico that would allow the latter to offer or to effectively grant to those corporations the benefits, protection, or advantages that Puerto Rico offers and grants [to] its residents," (footnote omitted) the requisite nexus was not established (A. 19). The Superior Court also based its holding on its judgment that were Puerto Rico permitted to tax foreign banks and corporations who lack any contacts with or

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[9] The Department of the Treasury initially claimed that the interest had been paid to Fenchurch, because of the way Gomez maintained its accounting records. The government later amended its answer to reflect the agreed fact that the interest was actually paid to the Japanese banks. A. 10.

[10] Although the banks were not themselves parties, Gomez clearly had standing to challenge the tax, *see International Harvester Co.* v. *Wisconsin Department of Taxation*, 322 U.S. 435, 440 (1944), and standing was never challenged below. *See also International Harvester Co.* v. *Secretary of Treasury*, Supreme Court of Puerto Rico (1983), reprinted at A. 30-36.

connections to the Commonwealth, the Commonwealth's economy would suffer from the resulting withdrawal of investment funds (A. 20).

On June 10, 1983, the Supreme Court of Puerto Rico, per Trias Monge, C.J., reversed. In a brief opinion the Supreme Court first held that the proper analysis of the tax was under the interstate and foreign commerce clause[11] (A. 3). Turning to that clause, the Supreme Court invoked *Complete Auto Transit* v. *Brady*, 430 U.S. 274 (1977) and *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979) as controlling authority; in applying those precedents, the court relied heavily on its own decision a month earlier in *International Harvester Co.* v. *Secretary of the Treasury*[12] (A. 3). As to the issue of nexus, the court cited to its analysis in *International Harvester*, where a Puerto Rican corporation had challenged the source tax as applied to an *American* bank doing no business within Puerto Rico (A. 4). In that case, the court had found sufficient nexus in the fact that out-of-state banks "benefit from the safeguards offered by the Puerto Rico legal and economic system" and the fact that repayment of the loan as well as the loan itself were tied to a commercial operation in Puerto Rico (A. 35-36).

Having disposed of the nexus issue by reference to *International Harvester*, the court next proceeded to consider briefly every commerce clause criteria set forth in the *Complete Auto*

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[11] While appellant's briefs below challenged the tax primarily on due process grounds, there can be no question that both the due process and commerce clause claims are properly before this Court on appeal. The fact that the Puerto Rico Supreme Court "reached and decided" the commerce clause claim — however presented — is dispositive. *Jenkins* v. *Georgia*, 418 U.S. 153, 157 (1974); *Whitney* v. *California*, 274 U.S. 357, 360-361 (1927); *Manhattan Life Insurance Co.* v. *Cohen*, 234 U.S. 123, 134 (1914). This Court "need not inquire how and when the question of the validity of the statute was raised when such question appears to have been actually considered and decided by [the lower] court." *Charleston Federal Savings & Loan Association* v. *Alderson*, 324 U.S. 182, 185-186 (1975). *See also Braniff Airways* v. *Nebraska State Board*, 347 U.S. 590, 598-599 (1954) (appellant framed his challenge to a state tax in terms of the commerce clause, and failed to invoke the due process clause; the Court held that "[t]hough inexplicit, we consider the due process issue within the clear intendment of such contention and hold such issue sufficiently presented").

[12] Because of the court's reliance on this case, and because it has yet to be officially reported in English, it is reprinted as Appendix F.

Transit — Japan Line test and answered each inquiry in favor of the constitutionality of the tax (A. 4-5).

On October 6, 1983, the Supreme Court of Puerto Rico denied appellant's motion for reconsideration (A. 8). On October 24, 1983, appellant filed a notice of appeal (A. 24).

The Questions Presented are Substantial.

The Commonwealth of Puerto Rico's remarkable attempt to lay claim to 29% of the gross interest income received by "*every foreign corporation or partnership not engaged in industry or business within Puerto Rico*, from sources within Puerto Rico," 13 L.P.R.A. § 3231 (emphasis added), disregards federal due process and commerce clause limitations on state and local taxation in an unprecedented fashion. The tax here goes beyond *any* that has ever been upheld by this Court; *never* has this Court allowed a state to tax where there is absolutely no activity — no agents, no offices, no property owned or contracts executed — within its borders.

In enacting so ambitious a tax, Puerto Rico wholly ignored the plain boundaries on state and local taxation repeatedly circumscribed by this Court. With regard to due process limitations on any state's jurisdiction to tax, "the simple but controlling question" remains the inquiry posed by Justice Frankfurter over forty years ago: "whether the state has given anything for which it can ask return." *Wisconsin* v. *J.C. Penney*, 311 U.S. 435, 444 (1940). The "closely related" requirement imposed by the commerce clause is that "'[s]tate taxation falling on interstate commerce . . . can only be justified as designed to make such commerce bear a fair share of the cost of local government whose protection it enjoys.'" *National Bellas Hess* v. *Dept. of Revenue*, 386 U.S. 753, 756 (1967), quoting *Freeman* v. *Hewit*, 329 U.S. 249, 253 (1946). More recently, the Court has made the commerce clause test yet more explicit, holding in *Complete Auto Transit* v. *Brady*, 430 U.S. 274, 279 (1977) that a state tax will survive commerce clause scrutiny *only* if it "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." And finally,

the Court has additionally demanded that when the state seeks to tax foreign — as opposed to domestic interstate — commerce, the tax must not only meet the four criteria set forth in *Complete Auto Transit*, but it must survive "a more extensive constitutional inquiry" focusing on whether it (1) subjects foreign commerce to an "enhanced risk of multiple taxation" or (2) "impair[s] federal uniformity in an area where federal uniformity is essential." *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 446-448 (1979).

Puerto Rico's unprecedented attempt at taxation of nonresident Japanese banks violates each and every one of these constitutional limitations, yet was nonetheless upheld by the Supreme Court of Puerto Rico. In so holding, the Puerto Rico Supreme Court issued a decision of critical importance not only to Gomez-Hermanos and the Japanese banks involved, but to the national and international banking industry as a whole. The development of multistate lending by major banks throughout the financial centers of the United States, and indeed the world, through independent loans and participation loans with other banks means that the types of transactions at issue here are hardly unusual or atypical. If Puerto Rico can constitutionally impose an *unapportioned* source tax on Japanese banks maintaining *no presence* whatsoever within its borders, merely because they exploit the Puerto Rican market, so can every state where any such lending activity takes place. The potential impact of the decision of the Puerto Rico Supreme Court is thus enormous. This Court must review and reverse that judgment.

I. Puerto Rico's Bold Attempt to Tax Foreign Lenders Whom it Concedes Engage in No Business Within Puerto Rico Violates Settled Due Process and Commerce Clause Limitations on State and Local Taxation.

A. *This Court has Never Before Allowed a State to Tax Interstate or Foreign Commerce Maintaining No Presence in the Taxing State.*

In exercising its duty "to make the delicate adjustment between the national interest in free and open trade and the legitimate interest of the individual States in exercising their tax-

ing powers," *Boston Stock Exchange* v. *State Tax Commission*, 429 U.S. 318, 329 (1977), this Court has never held, nor even intimated, that any state or commonwealth may extend its taxing arm outside its own boundaries to reach interstate or foreign commerce which enjoys no presence within the state. Yet Puerto Rico seeks unabashedly to wrap its taxing arm around the globe, undeterred by the constitutional requirement that there be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Bros.* v. *Maryland*, 347 U.S. 340, 345 (1954).

The Puerto Rico Supreme Court, under its novel analysis, would for practical purposes *eliminate* this Court's historic requirement that the taxing state have an actual connection to the putatively taxable business entity — whether that connection be denominated a due process "contact" or a commerce clause "nexus." The court below held that nexus was established merely because Puerto Rico provides a stable legal and economic system in which Gomez can prosper sufficiently to repay its debt.[13] Yet on several occasions this Court has forcefully repudiated the notion that the nexus required by the Constitution may be found in the connection between the out-of-state corporation and its *in-state consumers*, when that connection is unaccompanied by some *presence* by the out-of-state business in the taxing state.

National Bellas Hess v. *Department of Revenue*, 386 U.S. 753 (1967), put squarely the question of what *kind of connection* is required to support an exercise of state taxing jurisdiction that comports with commerce clause principles. The Court

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[13] In its opinion the Puerto Rico Supreme Court failed to explain what nexus it found. Rather, the court's one-sentence nexus holding simply referred summarily to its recent opinion in *International Harvester* (A. 4) — a case which involved not foreign, but domestic interstate commerce. In that case, the court had found that Puerto Rico had nexus to tax *American* banks on interest earned from Puerto Rican borrowers because of the "unquestionably close connections between Puerto Rico and the *taxable activity*," and because the Puerto Rican courts would protect the banks in the event of default. (A. 35-36) (emphasis added). In relying so heavily on *International Harvester*, the court not only ignored the critical difference between foreign and interstate commerce, *see* pp. 16-18, *infra*, but also ignored crucial factual differences in the two cases. In this case, the Japanese lenders were insured against default by MITI and would *never* have occasion to invoke Puerto Rico's judicial power. *See* pp. 22-28, *infra*.

explicitly rejected the argument — which is precisely the argument relied on by the lower court here — that the mere fact that a Missouri mail order merchant exploited the Illinois market satisfied the federal constitutional standard. Instead, this Court held that absent some index of *actual* presence within Illinois — for example, an office, telephone, employee, independent agency or property ownership, 386 U.S. at 754 — Illinois was not entitled to require the firm to collect a use tax from its customers. Nexus was not established where no more than common carrier or mail service linking the business to the state could be shown. *Id.* at 758.

Ten years later in *National Geographic Society* v. *California Board of Equalization*, 430 U.S. 551 (1977), the Court reaffirmed its commitment to an actual presence standard of nexus, this time holding that California could constitutionally compel the Society to collect a use tax from its mail order customers in California *only* because the Society operated two offices in the state — albeit offices handling a different segment of the Society's business — and these offices constituted the requisite "continuing presence" in the taxing state. In so holding, the Court underscored its presence standard by explicitly noting that its affirmance of the California Supreme Court on the merits was not to be confused with an adoption of that court's "slightest presence" test for nexus; the Court emphasized that it had *always* required "*much more substantial presence*" than the California test would imply. *Id.* at 556 (emphasis added).

The import of *National Bellas Hess* and *National Geographic* for the Puerto Rican tax at issue here is manifest. In these cases, this Court rejected the dubious taxing premise on which this levy is based — namely, that a state may tax any business entity who exploits that state's market, regardless of whether the entity has any other presence in the state. Furthermore, whereas the use taxes at issue in *National Bellas Hess* and *National Geographic* would have imposed *collection responsibility* on the interstate businesses but the ultimate *tax burden* on the *in-state consumers*, the Puerto Rican tax is a *direct tax* on the interstate and foreign business — a financial burden that even more strongly supports a "substantial presence standard," (*see* pp. 16-18, *infra*), for state taxation.[14]

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[14] Additionally, the use tax at issue in *National Bellas Hess* and *National Geographic* would have brought out-of-state merchants into *parity* with

Nor can Puerto Rico's tax escape the requirement of the federal Constitution because, as applied to banks, it taxes income from "intangibles" and not merchandise. This Court has historically extended to taxation of the interstate sale of insurance the principle of *National Bellas Hess* and *National Geographic* — that it is the state's connection to the putatively taxable business entity and not to consumers that makes the constitutional difference. In *State Board of Insurance* v. *Todd Shipyards*, 370 U.S. 451 (1962), for example, the Court held that the connection between the state of Texas and an insurer who maintained no presence within Texas was insufficient to support a 5% tax on the premiums paid to the insurer. In *Todd*, moreover, the insured property was located in Texas and the taxes were imposed on the insured residents — and still nexus was found wanting. *See also St. Louis Cotton Compress Co.* v. *Arkansas*, 260 U.S. 346 (1922); *Connecticut General Life Insurance* v. *Johnson*, 303 U.S. 77 (1938).

Given that in no case has this Court ever found nexus absent some physical presence by the out-of-state business,[15] Puerto Rico's historic attempt to tax Japanese banks who engage in no business in Puerto Rico, for transactions taking place entirely outside Puerto Rico, is entirely unprecedented. The Commonwealth cannot hold itself above the strictures of the commerce clause[16] and, indeed, the Puerto Rico Supreme Court

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local merchants already obligated to collect sales tax. Here, Puerto Rico's uniquely high levy on nonresident banks imposes on them an obvious disadvantage in competing with local banks. *See* pp. 16-18, *infra*.

[15] See, for example, the following cases where the Court explicitly conditioned its findings of nexus on the presence of an agent — even if an independent contractor — or an office within the taxing state: *Standard Pressed Steel* v. *Washington Revenue Department*, 419 U.S. 560 (1975) (company engineer); *Scripto, Inc.* v. *Carson*, 362 U.S. 207 (1960) (independent broker); *General Trading Co.* v. *Tax Commission*, 322 U.S. 335 (1944) (travelling company salesmen); *Nelson* v. *Sears, Roebuck & Co.*, 312 U.S. 359 (1941) (retail store outlet).

[16] As this Court has repeatedly asserted, the commerce clause limitations on state power to tax seek to protect "the free flow of trade between the states." *Freeman* v. *Hewit*, 329 U.S. 249, 252 (1946). It serves as a unifying and centralizing force against the "centrifugal, isolating or hostile forces" of localism, both social and economic. *See* Tribe, American Constitutional Law 319 *et seq.* (1978). There is no basis for assuming that under the negative implications of the commerce clause Puerto Rico can constitutionally practice economic or social isolationism and do what the fifty states

itself recognized that its tax laws are subject to scrutiny under that clause (A. 3). To be sure, Puerto Rico enjoys a special relationship to the United States government, *see Examining Board* v. *Flores de Otero*, 426 U.S. 572, 596 (1976). No case, however, has ever suggested that under the Constitution, Puerto Rico as a commonwealth enjoys *more sovereign* rights than the fifty states. Under the Constitution, Congress alone has plenary power to tax and regulate both interstate and foreign commerce — and that power allows the national government, like many sovereign nations,[17] to levy a comparable

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of the Union are not permitted to do. *First*, the Puerto Rico Federal Relations Act specifically prohibits Puerto Rican taxes which discriminate against interstate and foreign commerce. 48 U.S.C. § 741(a). *Second*, Puerto Rico's unique status of Commonwealth with "the degree of autonomy and independence normally associated with a state of the Union" and like a state "sovereign over matters not ruled by the Constitution," places Puerto Rico within the free market shielded by the commerce clause. *Third*, the rights of the people of Puerto Rico as United States citizens entitle them to the commerce clause protection against the parochial forces of economic localism, just as they are entitled to the Bill of Rights protection against unfair and oppressive action by the state. *See Shapiro* v. *Thompson*, 394 U.S. 618 (1969); *Rivera-Rodriguez* v. *Popular Democratic Party*, 457 U.S. 1, 7-8 (1982); *Torres* v. *Puerto Rico*, 442 U.S. 465, 469-70 (1979); *Examining Board* v. *Flores de Otero*, 426 U.S. 572, 594 (1976); *Calero-Toledo* v. *Pearson Yacht Leasing Co.*, 416 U.S. 663, 671-675 (1974); *Cordova & Simonpietri Insurance Agency, Inc.* v. *Chase Manhattan Bank, N.A.*, 649 F.2d 36, 40-41 (1st Cir. 1981).

[17] The fact that the *federal government*, exercising its powers as a fully sovereign nation, may levy a source tax on nonresident foreign corporations provides no authority for any state's attempt to do the same. *See F.W. Woolworth Co.* v. *Taxation and Revenue Department of New Mexico*, ____ U.S. ____, 102 S.Ct. 3128, 3134 (1982). As this Court has explained:

> Because the limitations of the Constitution are barriers bordering the States and preventing them from transcending the limits of their authority and thus destroying the rights of other States and at the same time saving their rights from destruction by the other States, in other words of maintaining and preserving the rights of all the States, affords no ground for constructing an imaginary constitutional barrier around the exterior confines of the United States for the purpose of shutting that government off from the exertion of powers which inherently belong to it by virtue of its sovereignty.

United States v. *Bennett*, 232 U.S. 299, 306 (1914) (federal government may tax United States citizen's foreign property while states may not). *See also Burnet* v. *Brooks*, 288 U.S. 378 (1933) (federal government may tax foreign securities owned by nonresident, but kept in United States, while states may

source tax on nonresident foreigners. Nowhere has Congress granted to Puerto Rico any special power to levy the tax challenged here — and in the absence of such a grant of power, Puerto Rico, like every state, is fully subject to the negative implications of the plenary national power to regulate interstate and foreign commerce.

This Court's due process and commerce clause nexus holdings mandate review and rejection of the Puerto Rico Supreme Court's radical revision of the nexus requirement. Were that court's holding — that Puerto Rico has nexus to tax nonresident banks who have neither offices nor personnel nor agents within Puerto Rico simply because the Puerto Rican market exists for the bank's debtor to earn money in — to stand, then the nexus concept would be illusory; it would be reduced to a *carte blanche* to the states to tax foreign corporations. Not even the "slightest presence" — the standard *rejected* as insufficient in *National Geographic* — would be required. Not even the use of common carrier or mail service

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not). Nor can the fact that Congress has decided to exempt Puerto Rico from the Internal Revenue Code be magically construed by the Commonwealth to confer on it the plenary power to lay a source tax on nonresident foreign commerce. The exemption from Federal Internal Revenue Laws was originally granted to Puerto Rico by Art. 14 of the Organic Act of April 12, 1900, ch. 191, Art. 14, 31 Stat. 80. The exemption was reaffirmed in the Organic Act of March 2, 1917, Ch. 145, Art. 9, 39 Stat. 954; 48 U.S.C. § 734. Under both Organic Acts, Puerto Rico was considered an "unincorporated territory." Legislative autonomy similar to that of the states in local matters was granted in 1917, but Congress retained all "major elements of sovereignty." *See Balzac* v. *People of Puerto Rico*, 258 U.S. 298 (1922); *Puerto Rico* v. *Shell Co.*, 302 U.S. 253 (1937); *Examining Board* v. *Flores de Otero*, 426 U.S. 572 (1976); *Cordova & Simonpietri Insurance Agency, Inc.* v. *Chase Manhattan Bank, N.A.*, 649 F.2d 36 (1st Cir. 1981). When in 1952 Puerto Rico's status changed from that of a mere territory to the unique status of Commonwealth, and became like a state "sovereign over matters not ruled by the Constitution," *Rivera-Rodriguez* v. *Popular Democratic Party*, 457 U.S. 1, 8 (1982), Art. 9 of the 1917 Organic Act was not repealed. It was retained as an essential part of the "compact" between Puerto Rico and the United States and became part of the Puerto Rican Federal Relations Act. Art. 9, 64 Stat. 319. In view of these historical antecedents, and of the anti-discrimination provisions of Art. 3 of the second Organic Act (48 U.S.C. § 741(a)) which were also retained as part of the Puerto Rican Federal Relations Act, it would be absurd to construe the exemption from federal income taxes to mean that Congress conferred thereby on Puerto Rico the plenary power to lay a source tax on non-resident foreign commerce, as if Puerto Rico were a sovereign nation with all the attendant prerogatives.

linking the banks to the jurisdiction — the connection *rejected* as insufficient in *National Bellas Hess* — would be required. Such evisceration of the nexus requirement plainly violates the Constitution.

B. *A State which Provides No Services to and Confers No Benefits on Nonresident Foreign Commerce May Not Constitutionally Compel that Commerce to Pay a Share of Local Costs.*

Closely related to the constitutional requirement of nexus is the concomitant requirement that "income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State.'" *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267, 273 (1978), quoting *Norfolk & Western R. Co.* v. *State Tax Commission*, 390 U.S. 317, 325 (1968) (due process standard). While "interstate commerce may be made to pay its way," in a state in which it does business, *Complete Auto Transit* v. *Brady*, *supra*, 430 U.S. at 288-289 n.15, it may not be charged for more than "its fair share of the costs of the state government in return for the benefits it derives from within the State." *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450, 462 (1959) (commerce clause standard). This "fair relation" requirement operates in close tandem with the nexus requirement; once a state has established the requisite threshold contacts with the foreign entity it seeks to tax, the constitutional inquiry turns to whether the burden for local costs that the state seeks to impose on the foreign entity is a fair one.

Once again the Puerto Rican statute disregards federal constitutional limitations imposing, as it does, a flat 29% tax on gross income earned by corporations whom it concedes — indeed *selects because* they — do no business within the Commonwealth. Having thus described the group of foreign enterprises who by definition have the least to do with local government, Puerto Rico can purport to confer *none* of the state services or benefits typically associated with the fair relation requirement, *e.g.*, fire or police protection, or local public works and services.

The Puerto Rico Supreme Court apparently premised its finding of the necessary "fair relation" on two principal

assumptions: (1) that the Japanese banks may rely on the Puerto Rican courts to enforce any debt claim on which Gomez may default and (2) that the mere fact that Puerto Rico provides an economy in which Gomez can earn income sufficient to pay its debt is essentially a "benefit" conferred on the banks by the Commonwealth of Puerto Rico. *See* A. 3-4; 35-36. Yet neither the facts in this case nor this Court's precedents support any such holding.

First, under the terms of MITI-guaranteed loans, it is the *Japanese government* — and not the Puerto Rican courts — who would protect the banks, Tozer and Toyota were Gomez to default on a loan.[18] Thus, the transactions which Puerto Rico claims are taxable establish *by their own terms* that the power of the Puerto Rican judiciary would never be invoked to protect the Japanese entities.

Second, the "benefit" Puerto Rico assertedly confers by providing a stable economy in which Gomez may prosper is a benefit conferred on Gomez — not on the banks. Under this Court's decisions, such a benefit *might* be a basis to meet the "fair relation" standard as to *Gomez*, *see Wisconsin* v. *J.C. Penney*, 311 U.S. 435, 444 (1940); but it provides neither the requisite nexus, *see* pp. 10-16, *supra*, nor the fair relation required before Puerto Rico can tax the foreign banks. The critical distinction, here as in the nexus cases, between a state's connections to a foreign corporation's *customers* and to the corporation *itself* is once again ignored by the lower court.

Third, even were the stable economy a "benefit" to the banks — a conclusion which can only be reached by overruling *National Bellas Hess* — the Puerto Rican tax code itself belies the claim that that benefit bears a "fair relation" to the 29% gross income tax imposed on the banks. While no taxpayer may reasonably demand that a state balance exactly the burdens and benefits resulting from a tax, *Commonwealth Edison Co.* v. *Montana*, 453 U.S. 609, 626-629 (1981), no such precise accounting is either required or sought here. For the fact is that the tax rate imposed on the foreign banks who have

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[18] See A. 11 (Superior Court finding of fact, ¶5). Indeed, under the 1971 Convention between the United States and Japan, loans guaranteed by the Japanese government are specifically exempted from all U.S. federal income taxes, see pp. 23-25, *infra*.

neither received nor solicited any state benefits or services is *higher* than that imposed on resident banks which obviously consume *more* state services and enjoy *more* benefits than foreign banks, *see* pp. 18-20, *infra*. In these circumstances, the absence of a "fair relation" is manifest.

C. *Puerto Rico's Tax Scheme Violates on its Face the Cardinal Commerce Clause Rule Against Local Favoritism.*

"From the quagmire [of commerce clause doctrine] there emerge . . . some firm peaks of decision which remain unquestioned," among them the principle that no state may "impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business." *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450, 458 (1959). The endurance of the absolute ban on state tax favoritism owes to the original purposes of the commerce clause: "[p]ermitting the individual States to enact laws that favor local enterprises at the expense of out-of-state businesses 'would invite a multiplication of preferential trade areas destructive' of the free trade which the Clause protects." *Boston Stock Exchange* v. *State Tax Commission*, 429 U.S. 318, 329 (1977), quoting *Dean Milk Co.* v. *Madison*, 340 U.S. 349, 356 (1951).

Although this Court could not have made plainer the scope and purpose of this rule, Puerto Rico has nonetheless designed a tax scheme which tax-favors enterprises resident in Puerto Rico. Foreign banks and businesses which do *no* business in Puerto Rico pay a tax of 29% of their *gross* income from sources within the Commonwealth. The tax rate on those doing business in Puerto Rico, by contrast, is 22% of normal tax *net* income — gross income reduced by the statutory array of deductions — plus a possible surtax on above normal-tax net income minus further tax credits.[10] That these two separate

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[10] *See* 13 L.P.R.A. §§ 3013, 3015, reprinted at Appendix E. Resident corporations are permitted to deduct from gross income, for example, all ordinary and necessary business expenses; interest paid or accrued; operating losses; casualty losses and losses from worthless stocks and securities; bad debts; depreciation; other income taxes and taxes for which a credit has been taken; legal expenses; insurance premiums paid; charitable contributions. 13 L.P.R.A. § 3023 (1976).

schemes do not even remotely produce equal taxation was explicitly recognized by the Legislature of Puerto Rico in 1975 — after the tax years at issue here — when it enacted a separate franchise tax on banks doing business in Puerto Rico to ensure that they bore their fair share of the Commonwealth's tax burdens.[20] In doing so, both the House of Representatives and the Senate of the Commonwealth of Puerto Rico specifically found that in 1973 — even as the Japanese banks were subject to taxes of 29% of *gross* interest income — banks doing business in Puerto Rico paid only *6.9%* of their *net* income in income taxes, and their total tax liability, including real and personal property taxes and municipal license taxes as well as income taxes, was still only *26%* of total *net* income.[21] Given the substantial costs which banks incur in attracting the funds which constitute loans, the difference between a 29% tax on gross income (the foreign rate) and a 6.9% (or even 26%) tax on net income (the domestic rate) is enormous.[22] Such patent discrimination cannot be ignored.

Just as the strictures of the commerce clause have doomed prior attempts at state tax favoritism — like New York's attempt to compel stock purchasers to trade on the New York exchange by imposing a large tax penalty for trading elsewhere, *Boston Stock Exchange* v. *State Tax Commission*, *supra* and

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[20] Law No. 34 of June 4, 1975, codified at 7 L.P.R.A. §§ 1171 *et seq.* (1976), reprinted at Appendix G.

[21] *See* the reports of the Senate and House Committees reprinted at Appendix G, including the Comparative Tax Table at A. 44-45.

[22] The existence of discrimination in the effective rates imposed by Puerto Rico is further evidenced by the widely-shared recognition in the international context that, if countries are to impose source taxes on *gross* income, those tax *rates* must be greatly restricted if they are to resemble at all what would be the regular business income tax in the source country (that is, the usual corporate tax on net income). Thus, the Organization for Economic Cooperation and Development (OECD) in its Model Treaty (Model Double Taxation Convention on Income and Capital, 1977), recognizing that banks and other lenders incur large expenses in attracting the funds for loans, set a maximum of *10%* on any source tax on interest income. *See* Surrey, *United Nations Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries*, 19 Harv. Int'l. L. J. 1, 25, 29 (1978). The 10% rate — which is also the source tax rate negotiated in the bilateral treaty between the United States and Japan, *see* pp. 23-26, *infra*, — stands in sharp contrast to the 29% tax imposed by Puerto Rico.

Virginia's attempt to favor local merchants by imposing a purportedly "neutral" license fee which fell disproportionately on interstate "drummers," *Nippert* v. *City of Richmond*, 327 U.S. 416 (1946) — so must the anti-parochialism animating the commerce clause block the Commonwealth of Puerto Rico in *its* attempt to disadvantage foreign banks lending funds to Puerto Rican residents.[23] That a "direct commercial advantage," *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450, 458 (1959), is afforded to Puerto Rican banks cannot be gainsaid. The disparate tax burden necessarily enables local banks to offer loans at more favorable rates, producing just the effect that the commerce clause forbids: effectively requiring certain "business operations to be performed in the home state." *Pike* v. *Bruce Church, Inc.*, 397 U.S. 137, 145 (1970).

The Supreme Court of Puerto Rico's disposition of the discrimination issue[24] — holding that discrimination would "really" exist if "foreign banks that are not authorized to do business in Puerto Rico were *exempted* from taxes on the interest earned" (emphasis added) while domestic banks were subject to tax (A. 4) — wholly misses the message of the commerce clause, which mandates *equal treatment* by states, not favoritism toward one or the other class of business.

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[23] Indeed, that Puerto Rico has chosen to discriminate against foreign, as well as interstate, commerce should subject its tax system to even "more extensive constitutional inquiry." *Cf. Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 446 (1979). The substantial risk of retaliation against American-owned corporations present in the foreign nations disadvantaged by state tax discrimination, and the inability of Congress or the Court to prevent such retaliation, mandate strict scrutiny of any tax scheme which on its face presents the risk of discrimination, and invalidation of what might, in the domestic context, be "deemed *de minimis*" discrimination, *id.* at 456.

[24] While the discrimination claim was not explicitly raised by appellant below, it is properly presented here because the issue was "reached and decided," *Jenkins* v. *Georgia*, 418 U.S. 153, 157 (1974) by the Supreme Court of Puerto Rico in its application of the *Complete Auto Transit* test. *See* A. 3-4); note 11 *supra*. Moreover, given the fundamental nature of the principle of non-discrimination under the commerce clause, *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450, 457 (1959), the decision to uphold a flatly discriminatory tax system is "plain error." *See Vachon* v. *New Hampshire*, 414 U.S. 478 (1974).

D. *A Flat State "Source Tax" on Foreign Commerce Inflexibly and Impermissibly Arrogates to the Taxing State Income Subject to Apportionment Among Interstate and International Jurisdictions.*

The source tax imposed by Puerto Rico on the interest paid by Gomez for the *entire* loan to each Japanese bank violates the commerce clause's further requirement of fair apportionment and raises the spectre of triple taxation of the same funds. The loan amounts on which the interest was paid not only covered the costs of the cars sold in Puerto Rico, but also their shipment from Japan, the MITI insurance purchased in Japan, and the 2% commission — roughly $60,000 — paid to Tozer for its efforts in Japan and to Fenchurch (a subsidiary of Tozer) for its efforts in New York. Moreover, the transactions themselves were arranged and executed not in Puerto Rico, but rather in Japan and New York. If *any* jurisdiction has the right to tax the entire loan interest, it is certainly not Puerto Rico; both the American Bar Association and the American Bankers Association take the position that the "source" for the income from a loan should be the domicile of the lender — not the borrower — since that is where the transaction takes place.[25] The Multistate Tax Compact, which has been adopted by twenty states, provides that interest income earned by foreign corporations doing business within and without the State be apportioned among the states according to a three-factor formula including property, payroll and sales.[26] But banks are excluded from this protection; "under current law a depository is taxable in every state which may constitutionally assert taxing jurisdiction," 34 Tax Lawyer 863 (1981) — a

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[25] *See* 34 Tax Lawyer 861-62 (1981) (Committee on Banking and Savings Institutions of the Tax Section of the American Bar Association); ACIR, "State and Local 'Doing Business' Taxes on Out-of-State Financial Depositories," Study under P.L. 93-100, S. Banking, Housing & Urban Aff. Comm., 94th Cong., 1st Sess. 674 (1975) (American Bankers Association).

[26] *See* 1 C.C.H. State Tax Guide § 351 at 359-60 (2d ed.). The Uniform Division of Income for Tax Purposes Act (UDITPA) approved in 1958 by the National Conference of Commissioners on Uniform State Laws, also contains allocation and apportionment provisions for interest income, and exemptions for banks, which are substantially similar to those contained in the Multistate Tax Compact Act. The Uniform Act has been substantially adopted by 24 states. *See id.* § 10-000 at 1017-20.

category which certainly includes New York as well as Japan. Thus, both Japan and New York could claim a right to tax, in whole or in part, the same income which Puerto Rico is taxing *in full*.

This is precisely what the commerce clause is intended to prohibit. While no specific apportionment formula is constitutionally mandated, *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267 (1978), Puerto Rico's refusal to recognize *any* need for apportionment betrays "[t]he vice characteristic of those [state taxes] which have been held invalid . . . that they have placed on the commerce burdens of such a nature as to be capable, in point of substance, of being imposed or added to with equal right by every state which the commerce touches." *Western Live Stock* v. *Bureau of Revenue*, 303 U.S. 250, 255-256 (1938) (citations omitted). And here, in particular, where international commerce is involved, even the *risk* of double taxation is sufficient to doom Puerto Rico's unapportioned tax. *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 451-452 (1979); *see* pp. 26-28, *infra*.

II. Puerto Rico's Unilateral Decision to Levy a Source Tax on Japanese Lenders Impermissibly Burdens Foreign Commerce.

Puerto Rico's source tax clearly fails to meet the commerce clause standards limiting state taxation of interstate commerce. Yet even were Puerto Rico able successfully to argue that the commerce clause tests should be recast and prior precedents overruled so as to validate its tax, § 3231 would nonetheless violate the Constitution. For what is at issue here, as the Supreme Court of Puerto Rico recognized,[17] is not interstate but foreign commerce. In *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 446 (1979), this Court explicitly *rejected* the argument "that the Commerce Clause analysis is identical regardless of whether interstate or foreign commerce is involved." Instead, the Court held that the "enhanced risk of multiple taxation" in the international context, where neither the Court nor the Nation can ensure full apportionment, as well as the Framers' intent to grant Congress greater power over foreign than interstate commerce, required "a

[17] *See* A. 1, 4 (applying *Japan Line* test).

more extensive constitutional inquiry" of state taxation of foreign as opposed to interstate commerce. Puerto Rico's source tax cannot survive that "more extensive" inquiry.

A. *Puerto Rico's Uniquely Burdensome Source Tax Impairs Federal Uniformity in Fashioning Policy for Trade with Japan.*

In seeking to tax the Japanese lenders in this case, Puerto Rico has sought as well to insert itself into the inherently federal domain of international trade relations. Foreign commerce is "preeminently a matter of national concern," *Japan Line, Ltd.* v. *County of Los Angeles, supra,* 441 U.S. at 448; both the commerce clause and the import-export clause reflect "the Framers' overriding concern that 'the Federal Government must speak with one voice when regulating commercial relations with foreign governments.'" *Id.* at 449, *quoting Michelin Tire Corp.* v. *Wages,* 423 U.S. 276, 285 (1976). Thus, this Court has recognized that with respect to foreign trade in particular, "the people of the United States act through a single government with unified and adequate national power." *Board of Trustees* v. *United States,* 289 U.S. 48, 59 (1933).

Here, the National Government has acted. *The Convention Between the United States of America and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,* signed by the President and ratified by Congress in 1971,[28] establishes a complex and precise structure for taxing loans made by Japanese lenders — loans which play a critical role in United States trade because of the volume of imports and exports traded with

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[28] *See* Prentice-Hall Tax Treaties §§ 54,032 *et seq.* The treaty itself was signed on March 8, 1971, entered into force on July 9, 1972, and governed taxes beginning on January 1, 1973. Thus, for the first two tax years at issue here, the treaty itself was not formally applicable. But with one exception — the exemption from tax for government-guaranteed loans — all of the provisions discussed here were also included in the governing 1954 convention as amended by the 1960 and 1962 protocols. *See id.* §§ 54,102; 54,127; 54,134. Under the provisions of the original 1954 convention the maximum source tax rate was 15%. The 1962 protocol reduced the maximum rate on source interest to 10%, effective as to payments made on or after January 1, 1966. *See id.* § 54,139.

Japan. Under the treaty, if the loan is from the Bank of Japan, or if the bank is a non-United States resident and the loan is a "debt obligation [ ] insured by the Government of Japan pursuant to the Law concerning Export Insurance of March 31, 1950 (Law No. 67)"[29] then the interest is wholly *exempt* from United States tax — source tax or otherwise. Alternatively, a "source tax" is imposed if the bank is a non-United States resident and the interest is earned on a loan not insured or guaranteed by the Japanese government. But the source tax under the treaty is limited to 10%. Finally, if the bank is a United States resident — as measured by whether the bank operates a permanent establishment in the United States — then it will be subject to the usual corporate tax rates, under which domestic banks are taxed, on its American income.[30]

The treaty is significant in two respects. *First*, it reflects a national policy to exempt from United States taxation — and thus to encourage — lending by the Bank of Japan (one of the banks from which Gomez borrowed according to the Superior Court's findings of fact, A. 11) as well as other Japanese banks where the loan is separately guaranteed by the government of Japan (as were the Gomez loans). This policy is ignored — indeed violated — by Puerto Rico, which would tax 29% of the

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[29] Article 13 of the treaty provides:

> (2) Notwithstanding paragraph (1) of this article interest derived from sources within the United States by the Bank of Japan or by the Export-Import Bank of Japan, or by any resident of Japan with respect to debt obligations guaranteed or indirectly financed by either of such banks or with respect to debt obligations insured by the Government of Japan pursuant to the Law concerning Export Insurance of March 31, 1950 (Law No. 67), shall be exempt from United States tax.

[30] Under the 1954 Convention, as amended, see note 28 *supra*, a foreign bank maintaining a permanent establishment in New York was subject to the usual corporate tax rates on all its American income. Under the 1971 treaty, such taxes are imposed only on income "effectively connected" with the bank's United States office. Any American income not "effectively connected" with such an office is subject to the maximum 10% source tax. The move away from the pre-1971 "force of attraction" principle suggests a federal concern for taxing foreign lenders: (1) at domestic rates only when their income is attributable to an *establishment which benefits from U.S. services*; and (2) at the *lower* of possible rates — and not, in any case, to tax them at higher than the applicable domestic rates.

interest on loans wholly exempted from tax by the federal government.[31]

In this sense, the case is on all fours with *Japan Line*: in both, there is a bilateral agreement between the United States and Japan to exempt certain items from taxation, reflecting "a national policy to remove impediments" to trade. 441 U.S. at 453. In both, the local tax "will frustrate attainment of federal uniformity." *Id.* Puerto Rico — no less than California — "by its unilateral act, cannot be permitted to place these impediments before this Nation's conduct of its foreign relations and foreign trade." *Id.*[32]

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[31] Although the President and Congress could have — but did not — include the states and the Commonwealth of Puerto Rico in all of the treaty provisions, silence cannot be deemed to license Puerto Rico or the states to *ignore* the treaty's contents and fashion separate policies and rules incompatible with the federal scheme. Were that the case, then states would be "free to impose demonstrable burdens on [foreign] commerce, so long as Congress has not preempted the field by affirmative regulation," *Japan Line, Ltd.* v. *County of Los Angeles, supra*, 441 U.S. at 433. Rather, "it long has been 'accepted constitutional doctrine that the commerce clause, without the aid of Congressional legislation . . . affords some protection from state legislation inimical to the national commerce, and that in such cases, where Congress has not acted, this Court, and not the state legislature, is under the commerce clause the final arbiter of the competing demands of state and national interests." *Id., quoting Southern Pacific Co.* v. *Arizona ex rel. Sullivan*, 325 U.S. 761, 769 (1945). Thus, although the treaty does not formally bind the states and Puerto Rico, this Court is obviously free to consider it a clear expression of the "national interest" in regulating trade with Japan against which conflicting local schemes must be measured.

[32] *Container Corporation of America* v. *Franchise Tax Board*, ____ U.S. ____, 103 S. Ct. 2933 (1983), is not to the contrary. That case involved a challenge by a domestic corporation to the particular apportionment method utilized by California in taxing that corporation's domestic and foreign income. The Court explicitly relied in its holding on the fact that the taxpayer was a *domestic* corporation doing business in California, "without a doubt amenable to be taxed in California," *id.* at 2956 — a point that the Court repeatedly stressed throughout its opinion, *see id.* at 2952, 2954, 2955. Not only did California clearly have the requisite "nexus" and contacts to tax the corporation, but it also employed a three factor apportionment formula in calculating the tax due — in sharp contrast to the unapportioned source tax imposed here. Moreover, while Container Corporation of America argued that California's taxing scheme would have negative effects on *its* foreign subsidiaries, the fact remains that a *state's* taxation of a domestic corporation poses far less direct and substantial threats to federal uniformity and control of foreign relations — and creates a less immediate risk of retaliation by the foreign governments — than a tax imposed by a state or commonwealth, as here and in *Japan Line*, directly on a foreign corporation. "[I]f a state tax merely has foreign resonances, but does not implicate foreign affairs, we can-

Second, the treaty undermines any claim by Puerto Rico that its source tax should be upheld because it is equivalent to federal taxes not applicable within Puerto Rico. In originally upholding the source tax in *International Harvester Co.* v. *Secretary of the Treasury*, the Puerto Rico Supreme Court noted that it corresponded to §§ 231 and 144 of the Federal Income Tax Law (A. 32). Yet these are the very provisions which, as to Japan, are modified by the treaty. As the treaty makes plain, the federal policy is to subject Japanese banks without offices in the United States to a maximum source tax of *10%*, while the policy of Puerto Rico is to impose on Japanese banks with no offices in the Commonwealth a source tax of *29%*.

Of course, the fact that Congress — with its plenary power to regulate foreign commerce — has the authority to impose a source tax does not strengthen the claim of the Commonwealth of Puerto Rico to do the same, *see* note 17, *supra*; indeed, if anything, it proves the contrary. Nor has Congress authorized Puerto Rico to impose *its* source tax in lieu of the federal tax. But even were it recognized that Puerto Rico enjoys greater fiscal autonomy than any of the fifty states, the fact remains that its source tax system is different from — and three times *higher* than — that imposed on foreign Japanese lenders by the federal government.

B. *Puerto Rico's Source Tax Subjects the Banks to an Unacceptable Risk of Multiple International Taxation.*

Puerto Rico's substantial flat-rate source tax exposes the Japanese banks to precisely the "enhanced risk of multiple taxation" proscribed by this Court in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. at 446. There, the Court held that any state tax on foreign commerce which creates the risk of multiple or overlapping taxation cannot survive commerce clause scrutiny; where *foreign* trade and taxation are con-

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not infer, '[a]bsent some explicit directive from Congress, . . . that treatment of foreign income at the federal level mandates identical treatment by the States.'" *Id.* at 2955, quoting *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425, 448 (1980). *Container Corporation* involved, at most, "foreign resonances"; the tax at issue here, like that in Japan Line, directly "implicate[s] foreign affairs."

cerned, even a fairly apportioned state tax may subject foreign commerce, "'"to the risk of a double tax burden to which [domestic] commerce is not exposed and which the commerce clause forbids."' *Evco* v. *Jones*, 409 U.S. [91, 94 (1972)] quoting *J.D. Adams Mfg. Co.* [v. *Storen*, 304 U.S. 307, 311 (1938)]." *Id.* at 448. And because the Supreme Court lacks the power to police the foreign government and insist that *it* fairly apportion the tax, the state tax must fall.

Here, the risk of double taxation is manifest. The banks involved are subject not only to taxation by Puerto Rico (and New York, where they have offices, and the United States government), but also to Japanese taxation. Japan has the "right and power" to tax its own corporations on their income from transactions entered into *in Japan*; "nothing could prevent it from doing so." *Japan Line, Ltd.* v. *County of Los Angeles*, *supra*, 441 U.S. at 454. The United States-Japan treaties, which do provide for reciprocal credits for taxes paid to the national governments, include no similar provision for taxes paid to the Commonwealth of Puerto Rico.[33] Japanese corporate tax law provides for tax credits for corporation taxes paid "in accordance with laws and orders of a foreign country," Corporation Tax Law of 1965, art. 69, but those credits are limited in amounts according to the overall percentage of its income which a Japanese corporation earns abroad and, under the treaty, there is nothing to stop Japan from denying any credit at all for Puerto Rican taxes.

The Constitution forbids Puerto Rico from creating this enhanced risk of multiple taxation. In foreign commerce, "[e]ven a slight overlapping of tax — a problem that might be deemed *de minimis* in a domestic context — assumes importance when sensitive matters of foreign relations and national sovereignty are concerned" (footnote omitted). *Japan Line, Ltd.* v. *County of Los Angeles, supra*, 441 U.S. at 456. Left to stand, the Supreme Court of Puerto Rico's decision — sanctioning the application of § 3231 to the Japanese banks and, accordingly, sanctioning the risk of overlapping international taxation — will leave unreviewable by "an[y] authoritative tribunal capable of ensuring that the aggregation of taxes is

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[33] *See* 1954 Treaty, *supra* note 28, art. 14; 1971 Treaty, *supra* note 28, art. 5.

computed on no more than one full value," *Japan Line*, at 447-448, a tax creating precisely the risk forbidden by this Court in *Japan Line*.

Conclusion.

For these reasons, this Court should note probable jurisdiction of this appeal and reverse the judgment of the Supreme Court of Puerto Rico.

Respectfully submitted,

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Appendix.

Appendix A.

IN THE SUPREME COURT OF PUERTO RICO

GOMEZ HERMANOS, INC.
Plaintiff-appellee NO. R-82-481 REVIEW
vs.
SECRETARY OF THE
TREASURY
Defendant-appellant

Opinion of the Court issued by Chief Justice Trias Monge.
San Juan, Puerto Rico, June 10, 1983.

The case presented herein has an analogous situation to the one decided by this Court in the case of *International Harvester Company of Puerto Rico, Inc.* v. *Secretario de Hacienda*, R-82-481, 83 J.T.S. 55, except that its contents involves or seems to involve international commerce.

The taxpayer corporation, Gomez Hermanos, Inc. ("Gomez Hermanos") is a corporation organized in Puerto Rico engaged in the importation, distribution and sale of Toyota motor vehicles and other. *Gomez Hermanos contested before the Superior Court a deficiency that was notified by the Secretary of the Treasury for failing to withhold taxes at its origin on certain years on the interest paid to Fenchurch Corporation ("Fenchurch"), a foreign corporation with offices in the city of New York.* The Court annulled the taxes upon considering it violated the due process clause for reasons similar to the

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/s/ ______________________
Official Court Interpreter and Translator
United States District Court
for the District of Puerto Rico

ones presented by the same forum in the case of *International Harvester*. We agree to review this decision. The facts are the following:

Toyota vehicles are manufactured by Toyota Motor Co., and sold by Toyota Motor Sales Co. Both companies have been organized and carry out business in Japan.

Tozer, Kensley & Millbound, Kabuschiki Kaischa ("Tozer") is a Japanese company, subsidiary of Tozer, Kelmsley, Millbound Ltd. of London, England. Tozer, according to the exportation system for Japanese products, is a mediator that acquires the vehicles and sells them to the holders of the franchise in foreign countries. Tozer engages in the compliance of the shipments to foreign countries with the regulations of the Ministry of Industry, Trade and Investment of Japan.

In order to import vehicles from Japan, Gomez Hermanos established credit lines with various Japanese banks, all of them having branches in the city of New York, but which do not carry out, nor are authorized to carry out business in Puerto Rico, nor have offices or agents herein. Tozer aided Gomez Hermanos in obtaining said credit lines.

In order to acquire said vehicles Gomez Hermanos would send its order to Toyota Motor Sales in Japan with copy to Tozer. Upon receipt of the purchase order thereto, Tozer made endeavors with one of the Japanese banks on behalf of Gomez Hermanos to advance the necessary amount to pay the acquisition expenses and others.

Toyota would forward to Tozer the corresponding invoice. Tozer, after calculating its commission and other expenses, obtained full payment for the invoice from the Japanese bank. Subsequently the Japanese bank would issue a draft on behalf of Gomez Hermanos to be paid at the offices of the drawee bank in New York. Non-negotiable copies of the draft and of the shipping documents were delivered to Tozer.

Upon receipt of the bank draft and the original of the shipping documents, the drawee bank's officers in New York would notify Fernchurch, Tozer's agent. On behalf of Gomez Hermanos Fernchurch would accept the draft issued and pick-up the shipping documents and forward the same. Gomez Hermanos would send on its due date a check on behalf of Fernchurch, drawed against Gomez Hermanos' account with a domestic bank, for the amount of the draft and said amount included interest on the loan thereof. *Fernchurch* would then pay the Japanese bank.

Gomez Hermanos' objection as to its obligation to withhold taxes at its origin set forth by section 231 of Act No. 91 of June 29, 1954, 13 PRLA, sec. 3231, is based on the due process clause. For the reasons set forth in *International Harvester* said objection is not proper.

We shall examine the facts of the case herein notwithstanding that Gomez Hermanos did not present the allegations herein before this forum, under the premise that the tax in question should be scrutinized from a point of view of its impact on foreign commerce.[1]

Today's interstate and foreign commerce are no longer considered exempted thereto, contrary to the doctrine of several years ago, from the state taxing powers. *Japan Line Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979).

In regard to interstate commerce, the case law thereto requires that taxing legislation complies with four requisites:

> *The tax must be applied to an activity that has a substantial nexus with the taxing state*; *the taxes must be distributed fairly*; *the taxes must not discriminate against in-*

---

[1] We can argue here, conceivably, if the facts are thus examined, that the problem is not the imposition of a tax to a foreign corporation engaged in foreign commerce, but a foreign company engaged in interstate commerce.

> *terstate commerce, and they must be properly related to the services provided by the state. Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 279 (1977); *Department of Revenue* v. *Association of Washington Stevedoring Co.*; 435 U.S. 734, 750 (1978).

When a state encumbers foreign commerce, two other factors must be also taken in consideration:

> The fact that the foreign company is subject to taxes; and also be determined if it is a field in which federal uniformity is essential. *Japan Line, supra*, 446-448.

In *International Harvester* we made reference to the doctrine of practical effects, which is the one to be followed in the analysis of the above issues. That means that a simple allegation, which has not been presented in the case herein, is not enough insofar as that a definite tax affects foreign commerce. *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267 (1978). This last condition is not present in the case herein. Nevertheless, the analysis made in *International Harvester* make us conclude that there is a substantial nexus between the taxing state and the activity subject to taxation, and that the tax is related properly to the services or the benefits provided by the state. The tax contested herein is not new. Its use is well known in the international practice. Surrey, "United Nations Group of Experts and the Guidelines for Tax Treaties between Developed and Developing Countries," 19 Harv. Int'l L. J. 1 (1978). It can neither be stated that the distribution of the tax is unfair — we are not dealing here with a tax as the one imposed in *Mobil Oil Corp.* vs. *Commissioner of Taxes*, 445 U.S. 425 (1980) — or *one that discriminates against foreign banks*. Unequalness would really arise if foreign banks that are not authorized to do business in Puerto Rico were exempted from taxes on the interest earned on account that said loans are to be used herein, *while all other banks all required to pay taxes*.

In regard to being exposed to or a possible exposure to double taxation, the record is totally insufficient to make a judgment as to that, as well as showing the need of a uniform federal treatment.

However, we must notice that the convention between the United States and Japan did not want to affect the state taxing powers in this type of situation. *Convention between the United States of America and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 23 U.S.T. 969 (1971).

Appealed judgment is repealed.

Jose Trias Monge
Chief Justice

CERTIFIED:
To be a correct translation prepared by:
/s/ ______________________________
Official Court Interpreter and Translator
United States District Court
for the District of Puerto Rico

IN THE SUPREME COURT OF PUERTO RICO

GOMEZ HERMANOS, INC.
Plaintiff-appellee

vs. No. R-82-481 REVIEW

SECRETARY OF THE TREASURY
Defendant-appellant

JUDGMENT

San Juan, Puerto Rico, June 10, 1983.

On account to the grounds set forth in the above opinion, judgment appealed is repealed.

It was decided and ordered by the Court and certify by the Clerk. Associated Justice Mr. Rebollo Lopez did not intervene.

Lady Alfonso de Cumpiano
Clerk

CERTIFIED:
To be a correct translation prepared by:
/s/____________________
Official Court Interpreter and Translator
United States District Court
for the District of Puerto Rico

IN THE SUPREME COURT OF PUERTO RICO

GOMEZ HERMANOS, INC.
Plaintiff-appellee
vs. No. R-82-481 REVIEW
SECRETARY OF THE TREASURY
Defendant-appellant

RESOLUTION

San Juan, Puerto Rico, June 30, 1983.

The second paragraph of the judgment issued on June 10, 1983, is amended *non pro tunc* as to the herein case to state that Associated Justice Mr. Davila did not intervene either.

It was agreed by the Court and certify 'y the Clerk. Associated Justices Davila and Rebollo Lopez did not intervene.

Lady Alfonso de Cumpiano
Clerk

CERTIFIED:
To be a correct translation prepared by:
/s/ ______________________________
Official Court Interpreter and Translator
United States District Court
for the District of Puerto Rico

Appendix B.

IN THE SUPREME COURT OF PUERTO RICO

GOMEZ HERMANOS, INC.
Plaintiff-appellee
vs. No. R-83-481 REVIEW
SECRETARY OF THE TREASURY
Defendant-appellant

RESOLUTION

San Juan, Puerto Rico, October 6, 1983

To the motion for reconsideration, denied.

It was agreed by the Court and certify by the Clerk. Associated Justices Davila and Rebollo Lopez did not intervene.

Lady Alfonso de Cumpiano
Clerk

CERTIFIED:
To be a correct translation prepared by:
/s/ ____________________
Official Court Interpreter and Translator
United States District Court
for the District of Puerto Rico

Appendix C.

IN THE SUPERIOR COURT OF PUERTO RICO

GOMEZ HERMANOS, INC. Plaintiff	CIVIL NO. 77-7967
vs.	RE: Review of Administrative Determination as to Tax Deficiency
SECRETARY OF THE TREASURY Defendant	

OPINION AND JUDGMENT

CASE HISTORY

The taxpayer, Gomez Hermanos, Inc., contests through the herein complaint the notice sent by the Secretary of the Treasury for interest and penalties for the tax years 1971, 1972 and 1973. The final deficiency notified to the plaintiff is based in that it failed to withhold income tax at its source on the interest allegedly paid to a corporation from the state of New York, N.Y., Fenchurch Corporation, hereinafter Fenchurch.

In its answer and in the Attorneys' Pretrial Conference Report that was filed by the parties hereto to be used as grounds for the Pretrial Conference Order, defendant, the Secretary of the Treasury, sustains there were sufficient contacts and nexus between Fenchurch and Puerto Rico to justify plaintiff's obligation to withhold from the former and pay to the defendant the amounts set forth in the Notice of Deficiency.

CERTIFIED:
To be a correct translation prepared by:
/s/ ______________________
Official Court Interpreter and Translator
United States District Court
for the District of Puerto Rico

After plaintiff[1] presented its evidence establishing that the interest referred to in this complaint was not paid to Fenchurch, but rather to a group of Japanese banks as we shall see further on, which do not have nor have had offices nor carried out business in Puerto Rico, defendant requested, and plaintiff did not object, to amend its answer to the complaint as well as the reasons for the notice of the deficiencies herein, so as to sustain that since the funds from which the interest were paid to Japanese banks originated from sources within Puerto Rico, plaintiff-taxpayer was bound to withhold and pay to the defendant income tax on said interest.

With said amendment defendant informed it would not offer evidence and requested a time period to file a brief to sustain its new avertment. The same was granted and plaintiff was given time to answer. After several extensions of time thereto the briefs were filed and the case was submitted.

In the Attorneys' Pretrial Conference Report, as well as at the beginning of the hearing, the parties stipulated and agreed that "all Toyota purchases made by the plaintiff during the years referred to in the Complaint had been made according to the documents which were similar to Tozer's invoice number 13703 to the plaintiff," for which reason we will make reference to said document to establish the facts insofar as all the transactions subject to the notice of deficiency contested herein.

From the examination of the parties' admissions and stipulations, including the ones set forth in the Attorneys' Pretrial Conference Report, and at the hearing, and the documentary evidence and the testimony presented by the plaintiff, the Court sets forth the following:

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[1] Both parties appeared at the hearing represented by their attorneys of record. Plaintiff presented the testimony of its Treasurer and General Manager, Victor M. Gomez, Esquire, and numerous documentary evidence. Defendant did not present any evidence.

FINDINGS OF FACTS

1. Plaintiff Gomez Hermanos, Inc., is a corporation organized and doing business pursuant to the laws of the Commonwealth of Puerto Rico, with main offices in San Juan, Puerto Rico. This corporation is engaged in the importation, distribution and sale of motor vehicles, auto parts and accessories thereto.

2. Plaintiff imported, distributed and sold during the taxable years 1971, 1972 and 1973, Toyota and Rambler motor vehicles.

3. Toyota vehicles for those years and at the present were manufactured by Toyota Motor Co., and sold by Toyota Motor Sales Co. These two companies have been organized and do business in Japan.

4. Fenchurch Corporation is a foreign corporation with offices in the city of New York, N.Y., which for the years referred to had no offices in Puerto Rico.

5. Tozer, Kensley & Millbound, Kabuschiki Kaischa, hereinafter Tozer, is a Japanese company, subsidiary of Tozer, Kemsley Millbound, Ltd., in London, England. Tozer acts as the trading company that pursuant to the exportation system for Japanese products happens to be the mediator that acquires those products and sells them to the holders in a foreign country of the franchise for the Japanese manufacturers, thus guarantee that all shipments to foreign countries comply with the regulations of the Ministry of Industry, Trading and Investment known by the initials MITI, and specifically the payment of the exportation insurance which protects all the Japanese manufacturers who export their products.

6. In order to be able to import vehicles from Japan, the taxpayer had to obtain credit lines with several Japanese banks, among them the Sanwa Bank, Misubishi Bank, Bank of Japan, and Bank of Tokio. All these banks have branches in

the city of New York, N.Y., but none of them have had offices nor have been authorized to do business, nor have carried out business of any type in Puerto Rico. In their endeavors and in establishing the credit lines with said Japanese banks, plaintiff's executives were accompanied and aided by Tozer's executives from Japan.

7. Plaintiff's purchase of Toyota vehicles in Japan, as shown by the sample invoice no. 13073 from Tozer, was through the Sanwa Bank, and took place as follows:

> Gomez Hermanos, Inc., placed its order with Toyota Motor Sales Co., Inc., in Japan, with copy to Tozer. Once the purchase order was received, Tozer made endeavors with one of the financing Japanese banks, on behalf of the plaintiff, for the advance of the amount necessary to pay the price to purchase the cars as well as all other expenses incurred by shipping.
>
> Toyota Motor Sales Co. invoiced Tozer for the cars, and the latter, after calculating all other shipping expenses, including interest to be paid to the Japanese banks on the expenses, the transportation insurance, its commission and all the other miscellaneous expenses, obtained payment for the total amount of the invoice from the financing Japanese bank. Said bank, on account of the loan or the advance thereof, issued a bank draft on behalf of the plaintiff to be paid at the offices of the drawee bank in the city of New York. The Japanese bank would forward to its office in the city of New York, N.Y., the original of the draft and the original documents for shipping. Non-negotiable copies of the draft and of the shipping documents were delivered to Tozer.
>
> Tozer in Japan was in charge of verifying that the vehicles being shipped were the ones included in plaintiff's purchase order to Toyota Motor Sales Co., that

all the shipping documents, including the Certificate or Origin, MITI's approval and insurance, ocean freight charges, the ship's departure and all other things regarding the shipment were in order so that upon its arrival in Puerto Rico they would be delivered to plaintiff without delay or problem.

For all these endeavors, Tozer collected and received a commission from plaintiff equivalent to 2% of the cost of the auto purchased and shipped by them. The amount of the commission was included in the bank draft issued by the Japanese bank on behalf of Gomez Hermanos, Inc. From said commission Tozer paid Fenchurch Corporation for the services provided in regard to the bank draft and documents thereof regarding the fulfillment of its obligation towards the plaintiff.

As we have stated before, Tozer would pay Toyota Motor Sales Co., on behalf of the plaintiff, with the advance made by the Japanese banks, the price of the vehicles so purchased and shipped, the insurance and all other MITI's charges, freight and ocean insurance and would collect its commission as well. Since the draft was for the same amount of the invoice, there appeared in each one of them the interest to be paid to the Japanese bank for the term in which the draft was to be paid. Upon receipt of the bank draft and the original shipping documents, the drawee Japanese bank's New York offices informed the offices of Fenchurch Corporation in that city that would be acting as Tozer's agent so that one of its employees and officers who had been previously authorized by the plaintiff, would accept the draft issued by the Japanese bank to Gomez Hermanos, Inc. Upon the assignees acceptance of the draft, an official employee would pick up the original shipping document and forward them to the plaintiff so it would be able to pick the

purchased vehicles upon their arrival to Puerto Rico for immediate sale.

On the date set for the draft issued by the Japanese bank that had been accepted by one of plaintiff's assignees in New York, N.Y., to become due, it would issue a check on behalf of Fenchurch Corporation against plaintiff's checking account with Banco Popular de Puerto Rico, San Juan Office, Puerto Rico, for the exact amount of the draft in order for said amount to be deposited in Fenchurch Corporation's checking account with the Japanese bank Standard Bank, Ltd., with offices in New York, N.Y. Upon receiving notice of the deposit, Fenchurch Corporation paid to the drawee Japanese bank the draft or drafts which covered the transfer, and would pick up the original or originals duly cancelled which were sent to plaintiff in Puerto Rico. Plaintiff's accounting book showed the purchase of the Japanese vehicles as "Accounts Payable to Fenchurch," which probably caused that defendant would originally notified the taxpayer of a deficiency for failing to withhold and pay to the Secretary of the Treasury a tax at its source for alleged interest paid to Fenchurch Corporation.

8. None of the Japanese banks to which Gomez Hermanos paid interest had nor have had offices in Puerto Rico, have not carried out business in Puerto Rico, nor have any connection or contact of any kind in Puerto Rico.

9. The interest paid by the plaintiff for the taxable years referred to in this case were from funds generated outside Puerto Rico without our government offering the sources that produced said funds any type of opportunities, advantages or protection.

10. It is true that the business which originated the funds to pay the interest were found in Puerto Rico, but it is also true

that without the funds generated outside Puerto Rico probably the funds to pay the interest could not have been generated.

11. The fact that plaintiff received invoices through Tozer, that said invoices were recorded in plaintiff's accounting book and that it would draw checks against the funds deposited in Puerto Rican banks, do not establish the nexus, contacts or connections that are necessary to impose income tax to the Japanese banks which never carried out business in Puerto Rico nor had offices herein.

12. The loans or credit lines referred hereto were never guaranteed nor are guaranteed at the present with any encumbrance on real estate property in Puerto Rico.

13. The above Findings of Facts, adapted to the American banks, as per stipulation of the parties, apply to plaintiff's purchase of those vehicles acquired from American Motors Corporation.

According to the above Findings of Facts, the Court sets forth the following:

CONCLUSIONS OF LAW

Section 231(a) of the Income Tax Act of 1954, as amended, 13 PRLA 3231(a), provides that there shall be levied, collected, and paid for each taxable year from foreign corporations not engaged in trade or business in Puerto Rico, an income tax for the interest originated from sources in Puerto Rico, of 29% of the total amount of the interest received in the taxable year.[2]

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[2] Said statute provides in its pertinent part:

"There shall be levied, collected and paid for each taxable year, in lieu of the tax imposed by section 3013 and 3015 of this title, upon the amount received by every foreign corporation or partnership not engaged in industry or business in Puerto Rico from sources within

Section 144(a) of said Act, 13 PRLA 3144(a), imposes to whomever pays interest to foreign corporations subject to taxation in Puerto Rico, the obligation to withhold a tax equivalent to a 29% of the amount paid to said foreign corporations subject to taxation in Puerto Rico.

Said section 144(a), 13 PRLA 3144 establishes in its pertinent part, 3144(a):

> "*Duty to withhold*: — In the case of foreign corporations and parterships subject to taxation under this subtitle not engaged in trade or business within Puerto Rico, there shall be deducted and withheld at the source, in the same manner and upon the same items of income provided in section 3143 of this title, a tax equal to 29 percent of said income. . ."

Section 1343(b) 13 PRLA 3143(b), imposes on the person obliged to withhold income tax at its source from foreign corporations subject to taxation in Puerto Rico the duty of paying to the Secretary of the Treasury the taxes withheld. The taxing obligation of a foreign corporation not engaged in trade or business in Puerto Rico has been submitted during numerous years to the scrutiny of our Supreme Court. In *Gallardo, Tesorero* v. *United P. R. Sugar Co.*, 42 DPR 646 (1931)[3] our

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Puerto Rico, as interest on loans made to International Banking Entities duly licensed under section 231a 231w of Title 7, and interest declared exempt under section 3144(b)(4) of this title, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodic gains, profits, and income, a tax of twenty-nine percent of such amount, and in the case of dividends and profit-sharing of partnerships, a tax of twenty five percent of the amount of such income.

[3] This case was affirmed by the Court of Appeals in 62 Fed. 2d 552, *Domenech, Tesorero* was substituted by *Gallardo, Tesorero* (Cert. denied by the U.S. Supreme Court, 289 U.S. 739).

Supreme Court, quoting from the case of *Farmers Loan Co.* v. *Minnesota*, 280 U.S. 204, page 651, states:

> "But the debts of a corporation, as well as the ones of individuals, are not property of the debtors in any way; they are obligations of the debtors, and they have value only in the hands of creditors. As to them they are property, and being in their hands, be subject to taxation. To designate the debts as the debtor's property is truly using the terms incorrectly. All property that may exist as to the debts of a corporation belongs to the creditors, to whom they are to be paid, and follow their domicile, whatever that may be. The debts cannot have a different domicile to the one to whom they are owed. This principle can be stated in various ways, and be sustained by several decisions, but no authority may add up anything to the evident truth which is acknowledged solely by stating the same."

Further on, page 652, states:

> "To summarize the main point, the position of the Supreme Court of the United States is that in the same way that the real estate and the tangible property under the due process of law can only have one situs for the purposes of taxation; likewise, except in very few instances, intangible property must have only one situs for the purposes of taxation. For the end of justice and convenience, the phrase "Mobilia seguuntur personam," is given the most ample application possible."

In the appeal of the above case, the Court of Appeals for the First Circuit, in *Domenech, Tesorero* v. *United Porto Rican*

Sugar Co., 62 F 2d 552, page 555, stating the constitutional standard for the case herein stated as follows:

> "We think it is indisputable that the tax is imposed on the nonresident creditor and is one measured by the income or interest on the loan or loans for a given year; that is not simply a tax on the credit or debt. The question then is whether the Legislature of Puerto Rico had jurisdiction and authority to levy an income tax upon nonresident creditor cororations which had no place or business in Puerto Rico and did no business there through agents or otherwise. The answer to the question is so self-evident that the mere statement of the proposition is its own answer. The Legislature of Puerto Rico is without authority or jurisdiction to impose a tax upon nonresident corporations measured by income earned or to be earned upon transactions entered into and wholly performed beyond the confines of Puerto Rico. It has no greater power in this respect than a state."

After a large number of cases developing the doctrine that places foreign corporations having no place or business in Puerto Rico under the taxing power of Puerto Rico when they have established sufficient nexus, contacts or connections with Puerto Rico, and as a consequence thereof they enjoy the protection, opportunities and advantages offered by Puerto Rico to its residents, the Supreme Court of Puerto Rico stated[4] in *Puerto Rico Telephone Co.* v. *Secretary of the Treasury*, 79 DPR 895 (1957) in page 925:

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[4]See also *The Fajardo Sugar Co.* v. *Sancho Rouret*, *supra*.

"The test in cases of this nature was perhaps stated best in *Wisconsin* v. *J. C. Penny Co.*, *supra*, 444-45: ". . ."Taxable event,' 'Jurisdiction to tax,' 'business situs,' 'extraterritoriality,' are all compendious ways of implying the impotence of state power because state power has nothing on which to operate. These tags are not instruments of adjudication but statements of result in applying *the sole constitutional test for a case like the present one. That test is* whether property was taken without due process of law, or, if paraphrase we must, *whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return. . . The fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction. . .*"
(Italics ours.)

The constitutional test authorizing Puerto Rico to impose taxes to foreign corporations that have no place nor carry out business in the Island is still that in order to be able to impose them the foreign corporation must have established sufficient nexus, contacts or connections with Puerto Rico that would allow the latter to offer or to effectively grant to those corporations the benefits, protection, or advantages that Puerto Rico offers and grants to its residents.[5]

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[5]See *C. H. Vehicle Leasing Corp.* v. *Commonwealth of Puerto Rico*, 107 DPR 94 (1978) and *United States Brewers Association, Inc.*, v. *Julio Cesar Perez, Secretary of the Treasury, et al*, 1980 C.A. 14, determined on February 28, 1980.

None of the Japanese banks to which plaintiff paid interest during the taxable years herein had offices nor carried out business in Puerto Rico, and the evidence clearly shows that none of those banks had contacts, nexus or connections of any kind whatsoever and therefore the Commonwealth of Puerto Rico did not offer to said banks the advantages, opportunities and protection of any type[8] that justify the imposition of taxes referred to in this lawsuit.

If defendant is authorized to impose taxes to foreign banks or entities in cases as the ones herein it will have the consequence of withdrawing significant sources of financing for business and industries in Puerto Rico, thus affecting the Island's industrial and commercial development.

The imposition of income tax to foreign corporations or banks as the ones involved herein would deprive them of their property without the due process of law.

Pursuant to the facts as established by the evidence presented and as set forth in our Findings of Fact, we are obliged to conclude that there were no contacts, nexus or connections of any kind between the transactions resulting in plaintiff's payment of interest to the Japanese banks nor has to the payment of said interest that justify the imposition of income tax on said interest without violating the due process of law.

To the contrary, we determine that whole essence of said contacts, nexus or connections presents a substantial and a valid constitutional issue to the imposition of said taxes. The taxable obligation imposed in the case herein is not related to subsequent opportunities and advantages granted by defendant and therefore it violates the due process of law clause as

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[8] We must point out that defendant's Memorandum of Law accepts that all the transactions which originated the obligations on which plaintiff pays the interest that the Secretary of the Treasury alleges as taxable, took place in Japan, that is, outside the territorial jurisdiction of Puerto Rico.

per the test established by the Supreme Court of the United States and our Supreme Court.

This conclusions of law also apply to the purchase of vehicles from American Motor Corporation.

Judgment shall be issued pursuant to the following Findings of Fact and Conclusions of Law.

TO BE REGISTERED AND NOTIFIED.

San Juan, Puerto Rico, August 31, 1982.

Sgd: Carmen Sonia Zayas
Superior Court Judge

CERTIFIED:
To be a correct translation prepared by:
/s/ ______________________________
Official Court Interpreter and Translator
United States District Court
for the District of Puerto Rico

IN THE SUPERIOR COURT OF PUERTO RICO
SAN JUAN PART

GOMEZ HERMANOS, INC. Plaintiff	CIVIL NO. 77-7967
vs.	RE: Review of Administrative Determination of Tax Deficiency
SECRETARY OF THE TREASURY Defendant	

JUDGMENT

Pursuant to the Findings of Fact and Conclusions of Law which are made part hereof, the Court renders judgment on behalf of Gomez Hermanos, Inc., and as a consequence thereof it annulls and vacates the Notices of Deficiencies made by the defendant, the Secretary of the Treasury for the taxable years 1971, 1972 and 1973.

The bond posted by plaintiff is cancelled and it shall be returned by the defendant, the Secretary of the Treasury.

TO BE REGISTERED AND NOTIFIED.

San Juan, Puerto Rico, August 31, 1982.

Sgd: Carmen Sonia Zayas
Superior Court Judge

CERTIFIED:
To be a correct translation prepared by:
/s/ ______________________
Official Court Interpreter and Translator
United States District Court
for the District of Puerto Rico

IN THE SUPERIOR COURT OF PUERTO RICO,
SAN JUAN PART

UNITED STATES OF AMERICA ss
THE PRESIDENT OF THE U.S.

GOMEZ HERMANOS, INC.
Plaintiff
vs.
SECRETARY OF THE TREASURY
Defendant

CIVIL NO. 77-7967 (1003)
RE: Review of Administrative Determination as to Tax Deficiency

NOTICE OF JUDGMENT

TO: Rodrigo Otero Suro, Esq., Box 1935, Hato Rey, P.R. 00919
Angel M. Aponte, Esq., Box 192, Old San Juan, P.R. 00902

THE UNDERSIGNED CLERK hereby gives you notice that the Court has rendered judgment in the case of caption on August 31, 1982, which has been duly registered and filed in the records thereto, where you can find the details as to the terms of the same.

And since you are, or you represent the party affected by the judgment, for which you may file an appeal, I hereby send you this notice after filing copy thereto in the records on September 9, 1982.

San Juan, Puerto Rico, September 9, 1982.

Belen Bonit: Clerk By: Rosa Mendez — Deputy Clerk

CERTIFIED:
To be a correct translation prepared by:
/s/____________________
Official Court Interpreter and Translator
United States District Court
for the District of Puerto Rico

Appendix D.

IN THE SUPREME COURT OF PUERTO RICO

GOMEZ HERMANOS, INC.
Plaintiff-appellee

vs.	REVISION
SECRETARY OF THE TREASURY	(R-82-481)
Defendant-appellant	APPEAL

NOTICE OF APPEAL TO THE UNITED STATES SUPREME COURT

Notice is hereby given that Gomez Hermanos, Inc., the appellant above named, hereby appeals to the United States Supreme Court from the final judgment of the Supreme Court of the Commonwealth of Puerto Rico entered herein on June 10, 1983 reversing the judgment rendered by the Superior Court of the Commonwealth of Puerto Rico in this case and upholding the validity under the Constitution, treaties and laws of the United States of Sections 144(a) and 231 of Act No. 91 of June 29, 1954 — 13 L.P.R.A. Secs. 3144 and 3231. Reconsideration of said final judgment was timely requested and denied by Resolution entered on October 6, 1983. This appeal is taken pursuant to 28 U.S.C. Sec. 1258(2).

San Juan, Puerto Rico, this 24th day of October, 1983.

SALDANA, MORAN & REY
Attorneys for Appellant
P. O. Box 13954
Santurce, Puerto Rico 00908
Tel. 724-5545

By: /s/____________________
Lino J. Saldana

CERTIFICATE OF SERVICE

I, LINO J. SALDANA, a member of the Bar of the Supreme Court of the United States, CERTIFY that on this 24th day of October, 1983 I served Appellant's Notice of Appeal to the Supreme Court of the United States by depositing a true copy thereof, with first class postage prepaid by certified mail, in a United States mailbox addressed to the following counsel of record and parties: Honorable Solicitor General of the Commonwealth of Puerto Rico; Miguel Pagan, Esq., Acting Solicitor General; and Justo Gorbea Varona, Assistant Solicitor General, Attorneys for the Secretary of the Treasury of Puerto Rico, to their address, Department of Justice, P. O. Box S-192, San Juan, Puerto Rico 00902; and to the Honorable Carmen Rita Velez Borras, Secretary of Justice, Department of Justice, P. O. Box S-192, San Juan, Puerto Rico 00902.

/s/ ______________________________

Lino J. Saldana
Counsel for Appellant

Appendix E.

Excerpts from the Puerto Rico Income Tax Act of June 29, 1954, No. 91, *As Amended* Up To December 31, 1973 (13 L.P.R.A. § 3001, *et seq.*) (1962)

TITLE 13. TAXATION & FINANCE

. . .

Subtitle 9. Income Tax Act of 1954

. . .

§ 3231. Tax on Foreign Corporations & Partnerships

(a) *Foreign Corporations or Partnerships Not Engaged in Trade or Business Within Puerto Rico.—*

(1) *In general.—*

(A) Tax Levy. — There shall be levied, collected, and paid for each taxable year, in lieu of the tax imposed by sections 3013 and 3015 of this title, upon the amount received by every foreign corporation or partnership not engaged in industry or business within Puerto Rico, from sources within Puerto Rico, as interest (except interest on deposits with persons engaged in the banking business, and interest declared exempt under section 3022(b)(4) of this title), dividends, partnership profits, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, a tax of 29 per centum of such amount. Provided, that in the case of dividends and partnership profits received from corporations or partnerships engaged in the operation of hotel, manufacturing or shipping businesses within Puerto

Rico, and derived solely from such hotel, manufacturing or shipping activities, the tax shall be 15 per centum of the amount of such dividends or partnership profits, and in the case of corporations and partnerships to which section 3144(b) of this title refers, that part, if any, of said 15 percent that may be taken as credit against the tax to be paid on said dividends or profits to the country where the corporation or partnership was organized. Provided, further, that the interest, dividends, partnership profits, and rents received by a foreign life insurance company, or by a foreign savings bank, shall be excluded in computing the gross income of a foreign life insurance company or a foreign savings bank. . . .

(b) *Foreign Corporations or Partnerships Engaged in Trade or Business Within Puerto Rico.* — A foreign corporation or partnership engaged in trade or business within Puerto Rico shall be taxable as provided in section 3013 and section 3015 of this title.

(c) *Gross Income.* — In the case of a foreign corporation or partnership gross income includes only the gross income from sources within Puerto Rico.

§ 3144. Payment of corporation or partnership income tax at source

(a) *Duty to Withhold.* — In the case of foreign corporations and partnerships subject to taxation under this subchapter not engaged in trade or business within Puerto Rico, there shall be deducted and withheld at the source, in the same manner and upon the same items of income as is provided in section 3143 of this title, a tax

equal to 29 per centum thereof, except that in the case of dividends and partnership profits paid by the corporations or partnerships engaged in the operation of hotel, manufacturing, or shipping businesses within Puerto Rico, and derived solely from such hotel, manufacturing or shipping activities, the deduction and withholding shall be made in an amount equal to 15 per centum of such income.

§ 3013. Normal tax on corporations and partnerships.

(a) *Definition of Normal-Tax Net Income.* — For the purposes of this subtitle, the term "normal-tax net income", when used with respect to corporations or partnerships, means the net income minus the credit for dividends or partnerships profits received, as provided in section 3026(a) of this title.

(b) *Imposition of Tax.* — There shall be levied, collected, and paid for each taxable year upon the normal-tax net income of every corporation or partnership (except corporations and partnerships subject to the tax imposed by section 3231(a) of this title or Supplement G) a tax of 22 per centum of the normal-tax net income.

(c) *Exempt Corporations.* — The corporations referred to in section 3101 of this title shall be exempt from taxation under this subtitle.

(d) *Improper Accumulation of Surplus or Profits.* — The surtax on corporations or partnerships which accumulate surplus or profits to avoid the tax on shareholders or partners, shall be that provided in section 3102 of this title. — June 29, 1954, No. 91, p. 474, § 13; June 20, 1970, No. 22, p. 446, § 1, eff. June 20, 1970.

§ 3015. Surtax on corporations and partnerships.

(a) *Surtax Net Income.* — For the purposes of this subtitle, the term "surtax net income", when used with respect to corporations or partnerships, means the normal-tax net income minus the credits provided in section 3026(b) of this title.

(b) *Imposition of Tax.* — There shall be levied, collected and paid for each taxable year upon the surtax net income of every corporation or partnership (except corporations and partnerships subject to the tax imposed by section 3231(a) of this title or Supplement G), a surtax as follows:

(1) Upon a surtax net income not over $75,000, 9 percent.

(2) Upon a surtax net income over $75,000, but not over $125,000, $6,750 plus 18 per centum of the amount of the surtax net income over $75,000. — June 29, 1954, No. 91, p. 474, § 15; June 20, 1970, No. 22, p. 446.

Appendix F.

IN THE SUPREME COURT OF PUERTO RICO

International Harvester Co.
of Puerto Rico
Plaintiff-Respondent
v. R-82-511 REVIEW
Secretary of the Treasury
Defendant-Petitioner May 10, 1983

OPINION OF THE COURT ISSUED BY
CHIEF JUSTICE TRIAS MONGE

In 1972, International Harvester Company of Puerto Rico, Inc. ("International Harvester"), a domestic corporation, borrowed the sum of two million dollars from Marine Midland Bank-Western ("Marine"). Marine is a bank, organized under the laws of the state of New York, which is not doing and has never done business in Puerto Rico. Marine neither has, or has ever had, an office or agents in Puerto Rico and is not related to International Harvester. The loan was negotiated and executed in Buffalo, New York, where the promissory note evidencing the debt was always kept. The installments of principal and interests were paid in Marine's offices in Buffalo.

During 1975 International Harvester borrowed a total of one million five hundred dollars from First National Bank of Maryland ("First National"). These loans were negotiated and executed in Chicago, Illinois. The related promissory notes were always kept outside Puerto Rico. First National has never done business in Puerto Rico, has no offices or agents here, and is not related to International Harvester. The installments of principal and interests were paid outside of Puerto Rico. None of these loans was secured by property located in Puerto Rico. The money received from these loans, how-

ever, was used for the operations of International Harvester in Puerto Rico and the interest was paid from International Harvester funds deposited in banks accounts in Puerto Rico.

On December 14, 1977, the Secretary of the Treasury, after holding an administrative hearing, served a final notice of deficiency on International Harvester in the amount of $229,479.02 on the grounds that the interests paid to Marine and First National were subject to withholding at the source. International Harvester contested the deficiency. The Superior Court invalidated the deficiency holding that the tax imposed violates the due process of law clause. The Treasury has petitioned this Court for review. It alleges that the Legislature of Puerto Rico has the power to require the related withholding in this type of cases. International Harvester argues that the levying of the tax violates due process of law. International Harvester makes no allegation regarding the effect of the withholding on interstate commerce.

During the years in question, Section 231 of Law Number 91, June 29, 1954, Section 3231 provided in part:

> "There shall be levied, collected and paid for each taxable year, in lieu of the tax imposed by sections 3013 and 3015 of this title, upon the amount received by every foreign corporation or partnership not engaged in industry or business within Puerto Rico from sources within Puerto Rico, as interest (except interest on deposits with persons engaged in the banking business, and interest declared exempt under section 3022(b) (4) of this title, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, a tax of 29 per centum of such amount. . ."

Section 144(a) of the related statute, 13 L.P.R.A., Section 3144(a) provides in part that:

> "In the case of foreign corporations and partnerships subject to taxation under this subtitle not engaged in trade or business within Puerto Rico, there shall be deducted and withheld at the source, in the same manner and upon the same items of income provided in section 3143 of this title, a tax equal to 29 per centum of said income. . ."

These provisions correspond to Sections 231 and 144 of the Federal Income Tax Law of 1938, 52 Stat. 447.[1]

International Harvester does not question the fact that, from a statutory point of view, interest received by foreign corporations is subject to tax. What it maintains is that the application of the statute to this case violates due process of law. Although the interested banks are not parties to this action, International Harvester has standing to raise said issue. *International Harvester Co.* v. *Wisconsin Department of Taxation*, 322 U.S. 435, 440 (1944).

Both in the case of similar taxes contested on the grounds of the due process clause as on those contested on the grounds of the interstate commerce clause, diverse myths and fictions have long affected the analysis of the problems posed. *Union Central Life Ins. Co.* v. *Tesorero de P.R.*, 19 D.P.R. 900 (1913), illustrates one of the incorrect approaches to the problem.

In *Union Central*, the Secretary of the Treasury levied a tax on the property of a foreign company that loaned money in Puerto Rico. The loans were secured by properties located here. The company was authorized to do business here and had a resident agent. The court devoted itself to inquire into

the *situs* of the assessed property. It held that it was a credit held by the foreign company and that, in accordance with the maxim *mobilia sequuntur personam*, such credits followed the person of the creditor. As the *situs* was outside Puerto Rico, the levying of a tax by Puerto Rico on such property, the Court held, violated due process of law.

In *Gallardo, Tesorero* v. *United P.R. Sugar Co.*, 42 D.P.R. 646 (1931), we again employed the *mobilia sequuntur personam* fiction. The problem in *Gallardo* was analogous to the one presented in the instant case. There the obligation of domestic corporations to withhold at the source certain tax on interest paid in the United States to various foreign corporations was contested. None of those corporations had an office or agent in Puerto Rico. The taxpayer's main argument was that the debts did not have a taxable *situs* in Puerto Rico. We agreed. We explained that "just as real property and tangible personal property, under due process of law, can only have one tax *situs*, likewise, with very limited exceptions, intangible property must have only one *situs* for tax purposes. In the interest of justice and convenience the amplest possible application is given to the maximum *Mobilia sequuntur* (sic) *personam*". (652)

In cases involving interstate commerce the principal difficulty stemmed from the ancient and inflexible doctrine that a state tax on any activity or process of commerce between the states constituted a null regulation. *Case of the State Freight Tax*, 82 U.S. (15 Wall.) 232 (1872) and *State Tax on Railway Gross Receipts*, 82 U.S. (15 Wall.) 284 (1872). Many state taxes of diverse types were invalidated by the blind application of this rule. Lockhart, "*A Revolution in State Taxation of Commerce*", 65 Minn. L. Rev. 1025, 1029 (1981). Over a century later, a series of cases, beginning with *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274 (1977) and *Department of Revenue* v. *Association of Washington Stevedoring Co.*, 435

U.S. 734 (1978), have been shaking the foundations of the rule. Both in due process and interstate commerce cases, the emphasis has devolved upon the examination of the practical effect of the tax and on the economic realities involved rather than on the automatic application of legalistic formalities.

With these developments in mind let us examine International Harvester's argument that under the facts of this case, the Legislature cannot, without violating due process of law, order it to withhold at the source 29% of the interest it pays to the foreign companies.

The due process of law clauses of the United States and the Commonwealth of Puerto Rico Constitutions impose two restrictions on the local taxation of income generated by an interstate business' activities. First, there must exist "some minimal connection between those activities and the taxing state". Second, "the income attributed to the state for tax purposes must be rationally related to 'values connected with the taxing state'". *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267, 273 (1978).

The second requirement does not concern us here, inasmuch as it essentially means that a state may only impose a tax on that portion of a multistate corporation's income that is rationally connected to the activities it performs within the state. See *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425 (1980).

As to the first restriction, the minimal connection does not need to be solely, as it has sometimes been incorrectly assumed, between the taxing state and the person or entity which finally bears the tax burden. The connection may also be between the taxing state and the taxable activity or transaction. *National Bellas Hess, Inc.* v. *Department of Revenue*, 386 U.S. 753, 756 (1967); *Moorman*, *supra*, 272-73. The determination of the required minimal connection is not an abstract mechanical exercise. Its approach must be eminently

pragmatic. Cf. *Concepcion Melendez Vda. de Miranda* v. *Secretario de Hacienda*, 83 JTS 38. Does the applicable activity touch upon any legitimate state interest or value? The paramount question is whether, within the reality of the economic world and the federate system we live in, the tax obligation is just or not.

When a clear connection exists between the foreign entity concerned and the taxing state, like an office or agent within the state, cases such as the present obviously do not pose a due process of law problem. Neither do they when the borrower is affiliated or intimately related to the lender. *P.R. Telephone Co.* v. *Srio. de Hacienda*, 79 D.P.R. 895 (1957). In the instant case, nevertheless, a superficial look at the facts appears to reveal no connection between the foreign banks and Puerto Rico. The due process of law clause, however, does not pose a simple challenge to the ingenuity of the designers of commercial transactions. A tax such as the present one is not invalidated simply by being careful to keep the lender removed from the taxing jurisdiction and the borrower, by executing the loan outside the taxing state and keeping the promissory note there, by not accepting real estate located in the taxing state as security, and by taking other similar precautions. None of this can hide the underlying realities in the instant case. The foreign bank loaned money to a domestic corporation for its use in Puerto Rico. The payment of the debt would come from properties located, and operations to take place, in Puerto Rico. Puerto Rico has a stable government that recognizes and protects debts and bank claims, both domestic and foreign. The Government of Puerto Rico allows International Harvester to deduct in its income tax returns the interest paid to the banks involved. It does not prohibit or limit the transfer of local funds to foreign countries for the payment of the debt. There exist unquestionably close connections between Puerto Rico and the taxable activity. Puerto Rico has a legitimate in-

terest on taxing it, and in effectively imposing said tax through withholding at the source on the interest accrued by such bank loans from foreign sources. Foreign banks benefit from the safeguards offered by Puerto Rico legal and economic system, under whose protection the funds needed to pay International Harvester's debt were generated.

Although International Harvester has made no allegation on the impact of the contested tax on interstate commerce, it must be pointed out that, even if it had, the argument could not have been seriously considered by this Court given the record in the instant case. The record totally lacks the economic data necessary to allow invalidation of a tax on such grounds. For the practical detail currently required of the record, see: *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267 (1978).

For the reasons stated herein above we hold that Sections 144(a) and 231 of Law No. 91 of June 29, 1954, 13 L.P.R.A. Sections 3144 and 3231, do not violate the due process of law clauses of the United States and Puerto Rico Constitutions.

The judgment under review is reversed.

JOSE TRIAS MONGE
Chief Justice

JUDGMENT

For the reasons stated herein above we hold that Sections 144(a) and 231 of Law No. 91 of June 29, 1954, 13 L.P.R.A., Sections 3144 and 3231, do not violate the due process of law clauses of the United States and Puerto Rico Constitutions.

The judgment under review is reversed.

So held and ordered by the Court and certified by the Clerk. Justice Irizarry Yunque did not participate.

Lady Alfonso de Cumpiano
General Secretary

FOOTNOTES 83 JTS 55

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[1] Section 231 provides:

> "There shall be levied, collected, and paid for each taxable year, in lieu of the tax imposed by sections 13 and 14, upon the amount received by every foreign corporation not engaged in trade or business within the United States and not having an office or place of business therein, from sources within the United States as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, a tax of 15 per centum of such amount. . ."

Section 144 states:

> "In the case of foreign corporations subject to taxation under this title not engaged in trade or business within the United States and not having any office or place of business therein, there shall be deducted and withheld at the source in the same manner and upon the same items of income as is provided in section 143 a tax equal of 15 per centum thereof. . ."

The interest rate was raised to 30% in 1942.

Appendix G.

Franchise Tax on Financial Institutions

7 L.P.R.A. Sec. 1171 et seq. (1976)

§ 1171. Short title

This chapter shall be known as "Financial Institutions Franchise Act". — June 4, 1975, No. 34, p. 73, § 1, eff. June 4, 1975.

§ 1172. Definitions.

As used in this chapter, when not clearly incompatible with the purposes hereof:

(a) Financial institutions. — The term "financial institution" means and includes:

(1) Any banking institution doing business in Puerto Rico under section 1 et seq. of this title;

(2) Any banking institution organized under the laws of the United States of America, doing business in Puerto Rico;

(3) Any savings and loan association organized under the laws of the United States of America, of any state of the United States of America, or under the laws of Puerto Rico, doing business in Puerto Rico;

(4) Any domestic savings bank doing business in Puerto Rico;

(5) Any mutual savings bank organized and operating under sections 1001-1046 of this title;

(6) Any trust company doing business and operating in Puerto Rico under the provisions of section 301 et seq. of this title;

(7) Any corporation or partnership doing business in Puerto Rico which is subject to the license requirements eligi-

ble under the provisions of sections 1051-1063 of this title, known as "Act to issue licenses to institutions engaged in the granting of mortgage loans, commonly known as 'Mortgage Banks' or 'Mortgage Brokers'";

(8) Any corporation or partnership organized and operating under the provisions of sections 661-683 of Title 10, known as the "Investment Companies Act of Puerto Rico" and any other investment company doing business in Puerto Rico, except when it distributes among its stockholders 90% or more of its annual net income;

(9) Any real estate investment trust doing business in Puerto Rico, except when it distributes among its stockholders 90% or more of its annual net income;

(10) Any other institution actively and regularly devoting over 50% of its current assets to the business of financing.

(b) Domestic. — The term "domestic" applied to corporations or partnerships means the financial institutions created or organized under the laws of the Commonwealth of Puerto Rico.

(c) Foreign. — The term "foreign" applied to corporations or partnerships means those financial institutions not domestic.

(d) Income Tax Act of 1954. — The term "Income Tax Act of 1954" refers to section 3001 et seq. of Title 13.

(e) Taxable year. — The term "taxable year" means the calendar or fiscal year as these concepts are defined in the Income Tax Act of 1954.

(f) Gross income. — The term "gross income" includes gains, profits and income derived from whatever source and in whichever form paid; or from industry, business, commerce or sales; or dealings in property, whether real or personal, arising from the possession or use or from equity in such property; also those deriving from interest, rent, dividends, partnership profits, securities, or the operation of any business for gain or

profit; and gains or profits and income derived from any source whatever. In the case of foreign financial institutions the term "gross income" shall include only the income derived from their operations in Puerto Rico, determined pursuant to section 3119 of Title 13.

To determine the income on interest attributable to the gross income of a financial institution for loans or transfers of money or its equivalent between the Foreign Financial Institution doing business in Puerto Rico, and other branch or office of the same institution doing business without Puerto Rico, there shall be considered and computed as applicable interest rate the interest rate prevailing on the market for obligations of the United States Government known as 90-day U.S. Treasury Bills, except when it is verified that the rate of interest paid has actually been higher.

(g) Net income. — The term "net income" means the gross income less the deductions allowed by section 3023 of Title 13 without including as deduction, both under such act or hereunder, the amount of the franchise tax herein provided, but including as deduction the income on interest derived from mortgage loans granted or secured by the Government of the Commonwealth, its agencies, municipalities and instrumentalities, issued after the approval of this act.

(h) Doing business in Puerto Rico. — The term "doing business in Puerto Rico" applied to financial institutions, means to carry out financial operations in Puerto Rico continuously and through offices or branches established in Puerto Rico.

(i) Secretary. — The term "Secretary" means the Secretary of the Treasury of Puerto Rico.

There shall not be allowed as deduction the interest paid by a Branch of a Foreign Financial Institution to another Branch or Office of the same Institution located without Puerto Rico in an amount exceeding the amount equivalent to the rate of

interest prevailing on the market for the obligations of the Government of the United States known as 90-day U.S. Treasury Bills, except when it is verified to the satisfaction of the Secretary that the amount of interest paid has actually been higher. —June 4, 1975, No. 34, p. 73, § 2, eff. June 4, 1975.

§ 1173. Exemptions

The provisions of this chapter shall not apply to the Government Development Bank for Puerto Rico, the Housing Bank of Puerto Rico, the *Banco Obrero de Puerto Rico*, the Cooperative Bank, the federal credit agencies, nor to Credit Unions organized under the General Cooperative Association Act of Puerto Rico. — June 4, 1975, No. 34, p. 73, § 3, June 4, 1975.

§ 1174. Imposition of franchise tax

(a) *Imposition.* — There shall be levied, collected and paid for each taxable year upon the net income of every financial institution for the privilege of doing business in Puerto Rico, a franchise tax equivalent to:

(1) 12 percent with respect to the taxable year commenced after December 31, 1974, but before January 1, 1976;

(2) 17 percent with respect to the taxable year commenced after December 31, 1975, but before January 1, 1977; and

(3) 22 percent for each taxable year commenced after December 31, 1976.

(b) *Credit on Franchise Tax.* — On the amount of the franchise tax levied in subsection (a) above, there shall be allowed for each taxable year, a credit equal to the amount of the tax paid or accrued under the Income Tax Act of 1954, section 3001 et seq. of Title 13.

(c) Except as established in subsection (b), the franchise tax provided in this chapter shall be levied, collected and paid in addition to other imposts, licenses, fees and any other taxes levied by other laws of the Commonwealth of Puerto Rico. —June 4, 1975, No. 34, p. 73, § 4, eff. June 4, 1975.

Excerpt from the Reports of the Finance Committee and the Committee on Consumer Affairs of the House of Representatives of the Commonwealth of Puerto Rico and the Finance Committee and the Committee on Socio-economical Development of the Senate of the Commonwealth of Puerto Rico on House Bill No. 1345 (enacted June 4, 1975). *

SCOPE OF THE PROVISION

The System of Taxation of Commercial Banks and some other Financial Institutions has been for some time cause for great concern in the island.

This has been due to the fact that the contribution these institutions make to the public treasury has not, by comparison, been proportionate to their economic capacity.

The very nature of banking activity and the make-up of their assets has permitted these institutions to legally benefit from certain provisions of the tax laws which exempt them from the payment of taxes on the interest income received from specific financial assets.

The enjoyment of said exemptions has considerably reduced their tax obligation, specifically their obligation under the Income Tax Act, to the point of eliminating it in some cases.

The situations has been further complicated because individual institutions are not subject equally to all Puerto Rico taxes. Of the 13 banking institutions doing business in Puerto Rico there is a group which is subject to all local taxes. These are the 8 banks organized under the Laws of Puerto Rico and the two foreign banks that operate in the Island. Banks organ-

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* The House report is dated May 7, 1975; the pages translated here are 4-6. The Senate report is dated May 9, 1975; the pages translated here are 1-3. Both reports delineate the purposes of the bill in identical terms.

ized under the United States Banking Laws did not pay municipal license taxes until recently and even now do not pay personal property taxes in the same manner as do the other banks.

Personal Property Tax is levied in a significantly different manner from that levied on other institutions. The difference lies in that the tax on personal property levied on banks is based on the market value of their shares (except national banks where it is based on the value of their furnishings and fixtures) while that levied on other enterprises is based on the appraised value of their inventories, furnishings, machinery, equipment, fixtures, vehicles and cash used as circulating capital.

There exists inequality in what is levied in each case. Clearly this is due to the provisions of Articles 317 and 320 of the Political Code which will be separately amended under HR bill 1344. Something similar occurs with respect to the new Municipal License Taxes law. Under its provisions the maximum rate at which banks and other financial institutions may be taxed is 1% while the corresponding tax rate for other enterprises is only 0.3%. Clearly this results in a heavier tax burden on banks than that imposed on other businesses.

In summary, we face three basic problems in the taxation of banking and financial institutions. First, because of the very nature of their activities, banks and some financial institutions contribute less to the public treasury by way of income taxes than other business enterprises. Second, the whole scheme of taxation of banks presents areas of inequality in taxation between banks themselves and between banks and other enterprises. Third, the scheme of taxation of banks includes laws with effects considered contrary to the best public interest.

By virtue whereof and for the purpose of ensuring these institutions pay taxes in a manner comparable to their economic capacity, we propose to establish a franchise tax that would apply equally to all institutions covered by it.

The franchise would tax the right to do business in Puerto Rico and would impose a 12% rate during its first year of application; 17% during the second year and 22% during the third and subsequent years, levied upon the net income without any exempt income allowance.

The measure would result in the following increase of tax payments made by banks and financial institutions:

COMPARATIVE TABLE OF TAXES PAID BY FINANCIAL INSTITUTIONS (THOUSANDS)

	YEARS				
	1973	1974	1975	1976	1977
A. Net income, total[1]	$36,888	$43,942	$40,433	$44,517	$51,170
B. Real property[2]	619	724	1,783	1,800	1,800
C. Personal property[3]	3,900	6,000	9,500	9,500	6,000
D. Municipal license tax[4]	2,530	3,332	3,200	3,500	3,800
E. Income tax	2,571	2,241	1,800	1,900	2,100
F. Sub-Total	9,620	12,297	16,283	16,700	13,700

[1] 1975, 1976 and 1977 figures are estimated.

[2] 1975 figures reflect the impact of the increase in the state tax rate.

[3] The actual method of levying the personal property tax is substituted in 1977 by the method utilized for all taxpayers. The series includes taxes levied upon two national banks currently under dispute before the courts and whose collection depends on the outcome of the litigation.

[4] Figures from 1974 on reflect the change in the method of application and the increase in the license tax rate.

G. Franchise Tax[5]	—	—	3,400	4,700	6,700
H. Total	9,620	12,297	19,683	21,400	20,400
I. Total adjusted net income (a + b + c + d)	43,937	54,005	54,916	59,317	62,770
J. Total tax (H) percentage of total adjusted net income	26.9%	22.7%	35.8%	34.4%	32.5%

[5] Calculations are based on:

12% of net income in 1975
17% of net income in 1976
22% of net income in 1977

Assuming a credit for income taxes paid. This credit will normally be less than the total tax paid, as each bank may only credit it up to the sum of the franchise tax. Included also is the exclusion of income from long term assets.

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